Golden Gate University Law Review

Volume 30
Issue 3 *Notes and Comments*

Article 8

January 2000

Valuation Discounts After Estate of Nowell v. Commissioner: A Clear Formula for Reducing Estate Taxes

Russell Stanaland

Follow this and additional works at: http://digitalcommons.law.ggu.edu/ggulrev

Part of the Taxation-Federal Estate and Gift Commons

Recommended Citation

Russell Stanaland, *Valuation Discounts After Estate of Nowell v. Commissioner: A Clear Formula for Reducing Estate Taxes*, 30 Golden Gate U. L. Rev. (2000).
http://digitalcommons.law.ggu.edu/ggulrev/vol30/iss3/8

This Article is brought to you for free and open access by the Academic Journals at GGU Law Digital Commons. It has been accepted for inclusion in Golden Gate University Law Review by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

NOTE

VALUATION DISCOUNTS AFTER *ESTATE OF NOWELL v. COMMISSIONER*: A CLEAR FORMULA FOR REDUCING ESTATE TAXES

I. INTRODUCTION

In *Estate of Nowell v. Commissioner*,[1] the Tax Court considered the issue of valuation discounts[2] on property for purposes of calculating federal estate and gift tax liability.[3] In its memorandum opinion, the court held that transferred property is valued without considering other similar property held by either the transferor or transferee for estate and gift tax purposes.[4]

The *Nowell* decision provided two important rules. First, a family may transfer property to various trusts and then claim that the total value of all trusts is worth less than the value of the underlying property because each trust owns only a partial share of the property.[5] This is true even when the family still owns and controls the trusts and, therefore, owns and controls

---

[1] 77 T.C.M. (CCH) 1239 (1999).

[2] *See infra* notes 35 – 83 and accompanying text.

[3] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1242 (1999).

[4] *See id.*

[5] *See id.*

Published by GGU Law Digital Commons, 2000

all the property.[6] Second, *Nowell* provides an additional valuation discount when an interest in a limited partnership is transferred and the transferee is treated as an assignee[7] as opposed to a substitute limited partner.[8] This discount is available even when the transferee owns one hundred percent of the remaining partnership, making the distinction between an assignee and a full partner irrelevant.[9]

Part II of this note will discuss the relevant law as it existed at the time Nowell was decided. Parts III and IV will then describe the circumstances surrounding the case and how it came to be heard by the court. Next, Part V will offer an explanation of the Tax Court's analysis, which will then be critiqued and supported in Part VI. Part VII will conclude this note by discussing a method by which to use the Nowell case to obtain maximum valuation discounts in estate planning.

To begin, it is important to note that *Nowell* is a Tax Court Memorandum case.[10] Generally, when the Tax Court designates a ruling as a "memo case," the case is simply restating existing law and does not set new precedent.[11] The case still carries the usual precedential value, but its value is lessened by its reiterative nature.[12] This classification, however, has not always been strictly followed.[13] The court may have used the memorandum designation in Nowell because it ruled only on cross-motions for partial summary judgment; nevertheless, Nowell is important for providing a bright-line rule for struc-

---

[6] *See id.*

[7] The distinction between an assignee and a partner is important because, in general, an assignee cannot exercise the normal rights of a partner. An assignee has only the right to the distribution of income from the partnership. An assignee can neither interfere in the management of the business nor require any information or account of partnership transactions. *See* 59A AM. JUR. 2d *Partnerships* § 506 (1987).

[8] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243 (1999).

[9] *See id.*

[10] *See id.* at 1239.

[11] *See* WILLIAM A. RAABE ET AL., WEST'S FEDERAL TAX RESEARCH 117 (2d ed. 1987).

[12] *See id.*

[13] *See id.*

turing estate plans to obtain the maximum valuation discount.[14]

II. BACKGROUND

A federal transfer tax is imposed on both the gifts a person makes during his or her life and the assets transferred at death.[15] Prior to 1976, two independent systems existed for calculating this estate tax: one for taxing the value of assets transferred at death and another for taxing inter-vivos transfers.[16] In 1976, Congress combined the two methods into a single unified gift and estate tax system, which today imposes a tax on the inter-vivos and testamentary transfer of wealth by every citizen or resident of the United States.[17] Only gifts valued at more than $10,000 per donee during a single calendar year are subject to tax; gifts valued at less than $10,000 per donee per year are exempt.[18] Because a person can make gifts to an unlimited number of donees each year, this annual exclusion is a much-used planning tool for reducing estate taxes.[19]

In calculating the estate tax, every decedent is allowed a unified credit[20] against the tax.[21] For 1999, this unified credit

---

[14] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243 (1999).

[15] *See* ROBERT A. ESPERTI ET AL., GENERATIONS - PLANNING YOUR LEGACY 7 (1999).

[16] *See* DOUGLAS A. KAHN ET AL., FEDERAL TAXATION OF TRUSTS AND ESTATES, 2 (3d ed. 1997)

[17] *See* I.R.C. § 2001(a) (1999). "A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." *Id.*

[18] *See* I.R.C. § 2503(b) (1999). Exclusion from gifts –

In General – In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year.

Id.

[19] For example, if a husband and wife have four married children, the husband and wife could each make a gift of $10,000 to each child and to each child's spouse. This would allow the husband and wife to reduce their taxable estate by $160,000 each year. *See* I.R.C. § 2503(b).

[20] Unified Credit Against Estate Tax is the title of I.R.C. § 2010, hence the term, "unified credit." However, in amendments to section 2010 in 1997 Congress uses the

eliminated the transfer tax on the first $650,000 of the estate and cumulative gifts of each decedent.[22] The credit amount increased to $675,000 in 2000 and increases in years thereafter until 2006 when the maximum credit will be $1,000,000.[23]

When the value of the estate and all taxable lifetime transfers exceed the amount of the unified credit, the unified gift and estate tax is imposed on the excess.[24] The tax rate begins at thirty-seven percent and increases to a maximum rate of fifty-five percent when the estate is valued at $3,000,000.[25]

These taxes, however, are not applied to the transfer by a decedent to the surviving spouse when the marital deduction is used.[26] That is, if certain requirements are met, transfers to a spouse are deducted from the value of the decedent's estate and thus not subject to the unified estate and gift tax.[27] One

---

term "applicable credit amount." I.R.C. § 2010(c). It is possible the term "unified credit" will be replaced with "applicable credit." I.R.C. § 2010 (c) (1999).

[21] *See* I.R.C. § 2010(a) (1999). "A credit of the applicable credit amount shall be allowed to the estate of every decedent against the tax imposed by section 2001." *Id.*

[22] *See* I.R.C. § 2010(c).

[23] *See id.*

In the case of a decedent dying and gifts made, during:	The applicable exclusion amount is:
1998	$625,000
1999	$650,000
2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
2006 or thereafter	$1,000,000

[24] *See* I.R.C. § 2001(c) (1999).

[25] *See* I.R.C. § 2001(c) (1999).

[26] *See* I.R.C. § 2056(a) (1999).

Allowance of Marital Deduction – For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes to or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Id.

[27] *See* I.R.C. § 2056(a).

requirement, called the terminable interest rule, is that the interest passing to the surviving spouse must pass freely and must not terminate or pass to another party unless the surviving spouse decides to do so.[28] The legislature, however, created a significant exception to this terminable interest rule for qualified terminable interest property ("QTIP"), which does not pass freely.[29] If the estate makes an election on the estate tax return to have the property treated as QTIP property, it will be treated as passing to the surviving spouse even though the surviving spouse has only a life interest, which extinguishes on the death of the surviving spouse, and no power to designate the beneficiaries.[30] When a QTIP election is made, the property qualifies for the marital deduction and, therefore, is not taxed in the estate of the first-to-die.[31] Absent a statute to the contrary, logic would not require the property to be taxed in the surviving spouse's estate because the surviving spouse only holds a life interest in the property.[32] The legislature, how-

---

[28] *See* I.R.C. § 2056(b).

General Rule – Where, on the lapse of time, or the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest.

Id.

[29] *See* I.R.C. § 2056(b)(7).

In General – In the case of qualified terminable interest property – for purposes of subsection (a), such property shall be treated as passing to the surviving spouse and, for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse. Qualified Terminable Interest Property Defined. – For purposes of this paragraph – In General – The term "qualified terminable interest property" means property – which passes from the decedent. in which the surviving spouse has a qualifying income interest for life, and to which an election under this paragraph applies. Qualifying Income Interest for Life. The surviving spouse has a qualifying income interest for life if – the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and no person has a power to appoint any part of the property to any person other than the surviving spouse. *Id.*

[30] *See id.* QTIP elections are typically used when there is a second marriage and children from the first marriage. The decedent wishes to provide income to the second spouse but ensure the children from a prior marriage receive an inheritance. *See* Kahn, *supra* note 16, at 292.

[31] *See* I.R.C. § 2056(b)(7) (1999).

ever, enacted such a statute to the contrary with section 2044 of the Internal Revenue Code (I.R.C.), which ensures that the property does not escape the transfer tax.[33] This section requires that the estate of the surviving spouse include the value of the QTIP property even though the surviving spouse held only an income interest that was extinguished on his or her death.[34]

A. PLANNING TO REDUCE ESTATE TAXES

1. Family Limited Partnerships

While taxes generally discourage large gifts, the use of family limited partnerships as a planning tool facilitates them.[35] When used for estate planning, two family members, typically a husband and wife, form a partnership and contribute assets.[36] The partners can then make annual gifts of ownership interests in the partnership worth $10,000 to their children instead of making gifts of the underlying assets owned by the partnership.[37] Numerous advantages in using this family limited partnership tool include the following:[38] a) parents are able to maintain complete control over the underlying assets if they own all of the general partnership interests; b) the parents can pay themselves most or all of the income from the

---

[32] *See* Terry S. Jones, Comment, *Estate of Bonner v. United States: QTIPS and Fractional Interest Discounts: Whipsaw Wonderland*, 33 IDAHO L. REV. 595, 608 - 609 (1997).

[33] *See* I.R.C. § 2044 (1999). This code section simply states that if the QTIP election is made on the estate tax return of the first spouse-to-die, then the property must be included in the estate of the second spouse-to-die:

(a) The value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying interest for life.

(b) This section applies to any property if –

a deduction was allowed with respect t the transfer of such property to the decedent under section 2056 by reason of subsection (b)(7) thereof.... *Id.*

[34] *See id.*

[35] *See* Esperti, *supra* note 15, at 271.

[36] *See id.*

[37] *See id.* at 272.

[38] *See id.*

partnership because they manage the partnership; c) the partnership interests given as gifts are subject to valuation discounts; d) the limited partners have limited liability.

The effect of the family limited partnership is that donors reduce the value of the assets in their estate on death, while maintaining control over and income from the assets during their lives.[39] Additionally, donors may distribute the limited partnership assets to the intended heirs and provide a plan of succession for the ownership of the businesses.[40] Family disagreements over ownership may also be reduced when assets are transferred during the parent's life.[41]

2. Valuation Discounts

Valuation discounts may be used to reduce the value of assets and the corresponding tax liability.[42] The Treasury Regulations define the value of property as the fair market value, which is "the price at which the 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."[43] In considering the fair market value, the regulations require the tax return filer to consider, "[all] relevant facts and elements of value as of the applicable valuation date . . . ."[44] For exapmple, if less than one hundred percent of an asset is transferred, the valuation of the transferred interest may be decreased by considering such factors as lack of control, inability to influence day-to-day management, liquidation rights, distribution of profits, and

---

[39] *See id.* at 274 – 275.

[40] *See* Esperti, *supra* note 15, at 274-275.

[41] *See id.* at 274 – 275.

[42] *See* Sharon J. Ritter, *A Historical Perspective on Minority Discounts*, 82 TAX NOTES TODAY 1993, 1993 (1999).

[43] Treas. Reg. § 20.2031-1(b) (as amended in 1965). "The value of every item of property includible in a decedent's gross estate under section 2031 through 2044 is its fair market value at the date of death...." *Id.*

[44] *Id.*

voting power.[45] These particular factors gave rise to the concept of minority interest discounts,[46] which is one way to reduce the value of transferred property.[47] It is important to note, however, that because families frequently transfer interests in closely held companies between family members for less than fair market value, the IRS closely scrutinizes the value placed on the interests transferred.[48]

Valuation can be difficult depending on the type of property.[49] Real property and publicly traded securities are relatively easy to value because there is a market where buyers and sellers engage in frequent transactions.[50] Closely held businesses, on the other hand, are more difficult to value because there are few owners and sales are infrequent.[51] The Treasury Regulations, nevertheless, offer some guidelines.[52] For example, Treasury Regulation § 20.2031-3 states that valuation of the goodwill of the business requires special attention.[53]

---

[45] *See* Ritter, *supra* note 44, at 193.

[46] *See infra* notes 55 - 63 and accompanying text.

[47] *See* Ritter, *supra* note 44, at 193. For example, if a piece of real estate is worth $100,000 a ten percent interest in that real estate is not worth $10,000 because the owner of the ten percent interest cannot force a sale of the property, cannot demand distributions of profits, or otherwise control and manage the property. *See id.*

[48] *See id.*

[49] *See id.*

[50] *See id.*

[51] *See* Ritter, *supra* note 44, at 193.

[52] *See* Treas. Reg. § 20.2031-3 (as amended in 1992).

The net value is determined on the basis of all relevant factors including –

A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including goodwill;

The demonstrated earning capacity of the business; and

The other factors set forth in paragraphs (f) and (h) of § 20.2031-2 relating to the valuation of corporate stock, to the extent applicable."

Id.

[53] *See id.* Although no definition for goodwill is provided by either the I.R.C. or the regulations, I.R.C., section 197(d) categorizes goodwill with going concern value, workforce in place, etc., thereby implying that goodwill is the same as going concern value, workforce in place, etc. From an accounting standpoint, goodwill is defined as

The use of family limited partnerships, combined with valuation discounts, provide planning opportunities to significantly reduce estate taxes.[54] Some of the more commonly used discounts include minority interest discounts, lack of marketability discounts, liquidation discounts and fractional interest discounts, each of which are discussed more fully below:

a. Minority Discounts

A person owning less than a majority of the managing interest cannot control or have a meaningful voice in the management of the assets.[55] This minority interest gives rise to the minority discount, which is based on factors such as lack of control, inability to influence day-to-day management, lack of liquidation rights, lack of control over distribution of profits, and limited voting power.[56] These minority discounts are available on both transfers at death and inter-vivos gifts.[57] However, the minority discount is not automatic.[58] A discount may be disallowed if the transferor made the transfer solely to fragment control over a block of stock to obtain a minority discount.[59] For example, in *Estate of Murphy v. Commissioner*,[60] the decedent held a power of appointment over a controlling

---

the excess of the total value of a business over the value of the specifically identifiable assets owned by the business. RICHARD A. BREALY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 834 (4th ed. 1991).

[54] *See* Eric Thomas Carver, *A Valuation Primer: Trends and Techniques for Estate Planners*, 77 MICH. B.J. 1304, 1304 (1998).

[55] *See* Ward v. Commissioner, 87 T.C. 78, 106 (1986). "The minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel a liquidation of corporate assets." *Id.*

[56] *See* Ritter, *supra* note 44, at 193.

[57] *See Ward*, 87 T.C. at 108. The court looked to the Treasury Regulations and found the gift tax regulations, as well as the estate tax regulations, rely on the willing buyer and willing seller rule to determine value. Specifically the court looked at regulation 25.2512-1, which states, "[t]he value of the 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 sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.512-1 (as amended in 1992).

[58] *See* Carver, *supra* note 56, at 1305.

[59] *See id.*

[60] 60 T.C.M. (CCH) 645 (1990).

block of stock in a closely held corporation representing 51.41% of the outstanding stock.[61] Eighteen days before her death, the decedent made gifts of .88% of the stock to each of her two children, thereby reducing her interest to 49.65%.[62] The court found that the sole purpose of this transfer was to obtain a minority discount for a controlling block of stock and disallowed the discount.[63]

b. Lack of Marketability Discounts

The lack of marketability discount recognizes that a stock interest in a closely held company has fewer potential purchasers than publicly traded stock.[64] In *Estate of Andrews v. Commissioner*,[65] for example, the decedent owned stock in four closely held corporations.[66] The court held that when the parties made no actual arm's-length sale with which to determine fair market value, alternate methods must be used to value an interest in a corporation.[67] Similarly, in *Estate of Folks v. Commissioner*,[68] the decedent owed a majority interest in a closely held corporation.[69] The court found that stock that was not freely and actively traded was subject to a "lack of marketability" discount equal to thirty-five percent of its appraised value.[70] Courts have thus upheld a lack of marketability dis-

---

[61] *See id.* at 645 (1990).

[62] *See id.*

[63] *See id.*

[64] *See* Carver, *supra* note 56, at 1306. "A discount for lack of marketability is defined as a discount from the normative value arising because of the inherent difficulty in the sale of an asset, requiring that the sale price between a willing buyer and a willing seller be reduced." *Id.*

[65] 79 T.C. 938 (1982).

[66] *See id.* at 938 (1982).

[67] *See id.* at 940. "In the absence of arm's-length sales, the value of closely held stock must determined indirectly by weighing the corporation's net worth, prospective earning power, dividend-paying capacity, and other relevant factors." *Id.*

[68] 43 T.C. M. (CCH) 427 (1982).

[69] *See id.* at 427 (1982).

[70] *See id.*

count in valuing both majority and minority interests in closely held companies.[71]

c. Liquidation Discounts

The cost of liquidating assets held by a corporation or partnership also reduces the value of an interest in the corporation or partnership.[72] For example, in *Estate of Dougherty v. Commissioner*,[73] the decedent owned one hundred percent of the stock of a corporation.[74] The court allowed a discount for the cost of liquidating the real estate held by a corporation.[75]

d. Fractional Interest Discounts

The fractional interest discount recognizes that less than one hundred percent of an asset is inherently less appealing to a purchaser than the entire asset.[76] This fractional interest discount differs from a minority discount in that a fractional interest discount may apply even if more than fifty percent of the asset is owned, as seen in *Estate of Pillsbury v. Commissioner*.[77] In *Pillsbury*, the decedent owned an undivided seventy-seven percent interest in real property.[78] The court recognized the effect of a fractional interest, even though it was a majority interest, and allowed a discount for co-ownership.[79] The court reasoned that a majority owner of the property needs an agreement or consent of the minority owner in order to exercise all of the rights of ownership.[80] The effect of a fractional interest discount is such that when two or more parties

---

[71] *See* Carver, *supra* note 56, at 1306.

[72] *See id* at 1307.

[73] 59 T.C.M (CCH) 772 (1990).

[74] *See id.* at 772.

[75] *See id.*

[76] *See* Carver, *supra* note 56, at 1307.

[77] 64 T.C.M. (CCH) 284 (1992).

[78] *See id.* at 286.

[79] *See id.* at 287.

[80] *See id.*

own property as co-tenants all of the owners have equal rights of possession.[81] Consequently an owner who holds less than a fifty percent interest may therefore restrict the actions of an owner of a majority interest.[82] This problem of concurrent ownership reduces the value of the shared interests and thus gives rise to a fractional interest discount.[83]

B. LEGISLATIVE HISTORY OF VALUATION DISCOUNTS

In general, the Internal Revenue Service ("IRS") does not endorse valuation discounts.[84] In fact, the IRS has fervently and consistently argued against their use in Tax Court because they can reduce tax liabilities of estates so dramatically.[85] Beginning in 1940 with Hooper v. Commissioner,[86] however, the Tax Court has frequently allowed the use of valuation discounts.[87]

1. Estate of Bright v. United States – An Attempt to Strike Down Valuation Discounts on the Transfer of Closely Held Stock

In *Estate of Bright v. United States*,[88] a seminal case in federal estate taxation, the United States Court of Appeals for the Fifth Circuit rejected the IRS's attempt to strike down a valuation discount on the transfer of stock in a closely held group of

---

[81] *See* Carver, *supra* note 56, at 1307. Each co-tenant has the right to equal use and possession of the property. *See id.*

[82] *See id.*

[83] *See id.*

[84] For an example of the Internal Revenue Service's argument against minority interest discounts on corporate stock see Estate of Bright v. United States, 658 F.2d 999, 1001 - 1002 (5th Cir. 1980) and *infra* part II.B.1. For an example of the Service's position on fractional interest discounts see Estate of Propstra v. U.S., 680 F.2d 1248, 1251 (9th Cir. 1982) and *infra* notes 135 – 148 and accompanying text.

[85] *See* Ritter, *supra* note 44, at 193.

[86] 41 B.T.A. 114 (1940).

[87] *See* Ritter, *supra* note 44, at 193.

[88] 658 F.2d 999 (5th Cir. 1981).

corporations.[89] In so doing, the court held that stock owned in part or in full by one spouse prior to death could not be attributed to the surviving spouse for purposes of valuing the property for the transfer tax.[90] Rather, the stock transferred by the deceased spouse should be valued independently of any stock held by the surviving spouse.[91]

In *Bright*, a husband and wife owned fifty-five percent of the stock of an affiliated group of corporations as community property.[92] The wife, who predeceased her husband, had devised her half, 27.5% of the stock, to a trust for the benefit of her children with the husband named as trustee.[93] This devise was subject to a transfer tax.[94] The value of the 27.5% of stock, however, could not be calculated on the basis of recent sales of the stock because the stock was not publicly traded.[95] Thus, the estate used an appraised fair market value and then claimed a fifty percent discount due to lack of liquidity and unmarketability of the minority interest.[96] The IRS disagreed with the discount and assessed additional tax and interest of more than $3,000,000 upon the estate.[97]

The estate paid the deficiency and instituted a suit against the IRS for a refund.[98] The district court held in favor of the

---

[89] *See id.* The *Bright* decision is important because it is the first appellate decision to reject the IRS's argument of family attribution. Subsequent decisions have relied on Bright to allow minority discounts. *See id.*

[90] *See id* at 1005.

[91] *See id.*

[92] *See Estate of Bright*, 658 F.2d at 1000.

[93] *See id.*

[94] *See* I.R.C. § 2001(a).

[95] *See Estate of Bright*, 658 F.2d 999, 1000 (5th Cir. 1980). The remaining forty-five percent of the stock not held by the decedent and her husband was owned by not more than four individuals with one person owning thirty percent. *See id.*

[96] *See id.* at 1008. In this case, an expert witness established the value of the stock. The dissent points out the value of the 27.5% interest was placed at $4,402,970 and a discount of fifty percent was used to reduce this to $2,201,485. *See id.* at 1000.

[97] *See id.* at 1000.

[98] *See id.* at 1000.

estate and the United States Court of Appeals for the Fifth Circuit affirmed.[99] During the appeal, the IRS agreed that the property to be valued was the property actually transferred, not the interest in the property held by the decedent before death or by the legatee after death.[100] Nevertheless, the IRS argued that the actual property in this case was an undivided one-half interest in a controlling fifty-five percent block of stock as opposed to the 27.5% interest in the corporation.[101] Accordingly, the IRS argued that the proper valuation method would be to assign a value to the whole controlling block and then use one-half of that amount as the value of the amount transferred.[102] This characterization would result not only in loss of the fifty percent minority interest discount, but would also give rise to a premium, and a subsequent increase in value, because of the husband's ability to control the corporation through ownership of more than fifty percent of the stock.[103]

The Fifth Circuit Court disagreed with this position, noting that under the community property laws of Texas, property is subject to partition at the request of either the estate or the surviving spouse.[104] Consequently, because the estate had no way to prevent the conversion of the controlling block into two

---

[99] *See Estate of Bright*, 658 F.2d at 999.

[100] *See id.* at 1001. This concept was established in United States v. Land, 303 F.2d 170 (5th Cir. 1962). In *Land* the decedent owned a partnership interest that was subject to a restrictive agreement that depressed the value of the interest. The restriction expired on the death of the decedent. The court held the restriction did not affect the value of the interest for estate tax purposes because the property is valued at the instant of death and at that time the restriction was no longer effective. *See Land*, 303 F.2d 170.

[101] *See Estate of Bright*, 658 F.2d at 1001.

[102] *See id.* This would completely eliminate the minority discount because by definition a minority discount is not allowed when more than fifty percent of the stock is owned. *See id.*

[103] *See id.*

[104] *See id.*

parts each holding a 27.5% interest, the estate's interest was limited to the value of a single 27.5% interest.[105]

Attempting to find another way to strike down the discount, the IRS argued for the application of the family attribution principle, which gives constructive ownership to one family member of stock actually owned by another member.[106] The IRS reasoned that because the husband and wife owned the stock as a control block during their lives and because the husband continued to control the entire block after her death, he would not sell the estate's shares as a minority interest.[107] Under this reasoning, the transferred stock should be valued as part of the fifty-five percent block, thus eliminating the discount.[108]

The Fifth Circuit Court rejected the government's family attribution argument for three reasons.[109] First, case law suggested that the principle was inapplicable.[110] For example, in *Estate of Lee v. Commissioner*,[111] a husband and wife owned, as community property, most of the stock in a closely held corporation and upon the death of the wife, the stock passed to the husband.[112] The court held that the transferred stock was to be valued as a block separate from the shares owned by the hus-

---

[105] *See Estate of Bright*, 658 F.2d at 1001. The court cited Estate of Lee v. Commissioner, 69 T.C. 860 (1978), as support for this position. In *Lee*, a husband and wife each owned, as community property, eighty percent of the common stock and one hundred percent of the preferred stock of a corporation. The court found that upon the death of the wife, her estate held forty percent of the common and fifty percent of the preferred stock. *Id.* (citing *Estate of Lee*, 69 T.C. at 874).

[106] *See id.*

[107] *See id.* at 1002. To support the idea of the estate continuing to have control of the stock after death of the devisee, the government relied on the fact that the husband was the executor of the estate and trustee. The fiduciary duty from such a position, presumably, prevented him from partitioning the stock and reducing its value. *See id.*

[108] *See Estate of Bright*, 658 F.2d at 1002.

[109] *See id.*

[110] *See id.*

[111] 69 T.C. 860 (1978).

[112] *See Estate of Bright*, 658 F.2d at 1002 (citing *Estate of Lee*, 69 T.C. at 874).

band.[113] Similarly, in *Estate of Heppenstall v. Commissioner*,[114] the taxpayer owned 2,310 shares, representing more than fifty percent of the stock in a family corporation.[115] He made gifts of three hundred shares each to his wife and three children for a total transfer of 1,200 shares.[116] The Tax Court allowed a discount, reasoning that while the donor no longer held a controlling share, he made gifts of less than fifty percent and thus did not convey control to any single donee.[117] Likewise, in *Estate of Phipps v. Commissioner*,[118] the taxpayer made gifts of stock to several family members and argued for family aggregation[119] on the theory that, when combined, the gifts represented so large a portion of the corporation that a blockage discount applied.[120] Consistent with other family aggregation cases, the *Phipps* court held that each gift should be valued separately.[121] Finally, in *Whitemore v. Fitzpatrick*,[122] the taxpayer, who owned all 820 shares of a corporation, made gifts of 200 shares to each of his three sons.[123] The court held that gifts to separate donees should be valued separately and thus a minority discount applied.[124]

---

[113] *See id.* (citing *Estate of Lee*, 69 T.C. at 874).

[114] 8 T.C.M. (CCH) 136 (1949).

[115] *See Estate of Bright*, 658 F.2d at 1003 (citing Estate of Heppenstall v. Commissioner, 8 T.C.M. (CCH) (1949)).

[116] *See id.*

[117] *See id.*

[118] 127 F.2d 214 (10th Cir. 1942).

[119] The terms "family aggregation" and "family attribution" have essentially the same meaning. *See Estate of Bright*, 658 F.2d at 1004 (citing Estate of Phipps v. Commissioner, 127 F.2d 214 (10th Cir. 1942)).

[120] *See Estate of Bright*, 658 F.2d at 1004. A blockage discount refers to the situation that occurs when a single person holds so large a share of the stock that to sell the stock would have a depressing effect on the price. *See* CCH, Federal Tax Service § O:2.40.

[121] *See Estate of Bright*, 658 F.2d at 1004 (citing *Estate of Phipps*, 127 F.2d 214).

[122] 127 F. Supp. 710 (D. Conn. 1954).

[123] *See Estate of Bright*, 658 F.2d at 1004 (citing Whitemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954)).

[124] *Id.*

The second reason the Fifth Circuit Court rejected the principle of family attribution is because it is inconsistent with Treasury Regulations and the willing buyer-seller rule contained therein.[125] Regulation 20.2031-1(b) states that when determining fair market value one must look to the price at which the property would change hands between a willing buyer and seller when neither is coerced to act and both have knowledge of all relevant facts.[126] Under this scenario, the willing seller is not the actual seller, but rather a hypothetical seller who cannot be assumed to own property other than that which is the subject of the valuation.[127] This idea is supported by the concept that the estate tax is a tax on the transfer of property at death and that the valuation of property transferred is determined at the moment of death.[128] "It would be strange indeed if the estate value of a block of stock would vary depending on the legatee to whom it was devised."[129]

The third and final reason the court rejected the family attribution principle was to maintain a stable and predictable body of law.[130] This stability is especially important in tax law because of the widespread reliance on established principles

---

[125] *See id.* at 1005 (citing Treas. Reg. 20.2031-1(b) (as amended in 1965)).

[126] *See* Treas. Reg. 20.2031-1(b). "The fair market value is the price at which the 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." *Id.*

[127] *See Estate of Bright*, 658 F. 2d at 1005. If the willing seller were assumed to be the actual estate it would be reasonable to assume that all of the stock would be sold as a block in order to reap the additional profit that a controlling interest is worth. If the willing buyer is assumed to be the actual legatee, who already owns a portion of the stock, it is reasonable to assume the buyer would be willing to pay a premium to obtain a controlling interest. The hypothetical seller-buyer rule, moreover, requires that property already in the hands or the buyer or seller must be ignored for valuation purposes. *See id.*

[128] *See id.* at 1006. Here the court once again states the value is based on the interest that is actually transferred, not on what was owned by the decedent before death or what was owned by the surviving spouse after death. *See id.*

[129] *Id.*

[130] *See Estate of Bright*, 658 F.2d at 1006. This policy important in tax law because taxpayers rely on established principles to plan their affairs. *See id.*

when planning a taxpayer's affairs.[131] Consequently, the Bright court concluded that family attribution should not apply to stock for estate valuation purposes.[132]

The IRS responded to the *Bright* holding by issuing Revenue Ruling 81-253 in which it announced non-acquiescence.[133] The Ruling stated that, despite the outcome in *Bright*, the IRS would not allow minority discounts with respect to transfers between family members unless it found evidence of family discord or other factors indicating that a family could not act as a unit.[134]

2. Estate of Propstra v. United States – Congressional Intent With Respect to Valuation Discounts and Aggregation of Holdings

In *Estate of Propstra v. United States,*[135] the United States Court of Appeals for the Ninth Circuit clarified the holding in Bright when it analyzed the language of the Treasury Regulations in its attempt to determine the intent of Congress with respect to family aggregation rules.[136] In Propstra, the husband died owning an undivided one-half community property interest in several parcels of real estate, all of which passed to his surviving wife who owned the other one-half interest.[137] On the husband's estate tax return, the estate claimed a fifteen percent discount for lack of marketability.[138] The government disputed the discount and argued that the taxpayer must show

---

[131] *See id.*

[132] *See id.*

[133] *See* Rev. Rul. 81-253, 1981-2 C.B. 187. If the Internal Revenue Service disagrees with a court ruling it announces "non-acquiescence." This means the IRS will follow the ruling only for the specific taxpayer whose case resulted in the ruling, but will continue to follow what it considers to be the correct interpretation of the law when dealing with all other taxpayers. *See* Raabe, *supra* note 11, at 94.

[134] *See* Rev. Rul. 81-253, 1981-2 C.B. 187.

[135] 680 F.2d 1248 (9th Cir. 1982).

[136] *See id.* at1251.

[137] *See id.* at 1250.

[138] *See id.*

that the two interests are likely to be sold separately before claiming the discount.[139] In support of this argument, the IRS stated that, under the unity of ownership principle,[140] it could reasonably assume that the interest held by the estate would eventually be sold with the other undivided interest.[141]

The Ninth Circuit, as had the Fifth Circuit in Bright, looked to the definition of fair market value in Treasury Regulation 20.2031-1(b) and decided that its language did not require application of the unity of ownership rules.[142] Congress, rather than explicitly ordering the application of unity of ownership rules as it had done in other areas of tax law, simply was silent.[143] The Propstra court reasoned that because the statute lacked specific language requiring family aggregation, it would not assume that Congress intended the family attribution rules to apply in estate tax situations.[144] Consequently, the Ninth Circuit in Propstra rejected the government's argument for using the objective standard of a hypothetical buyer and seller in order to avoid uncertainties involved in forcing executors to make inquiries into the feelings, attitudes and anticipated behavior of those holding undivided interests in property.[145]

In 1993, after further consideration of Ruling 81-253 and in light of several other cases rejecting the family aggregation principle,[146] the IRS revoked it non-acquiescence.[147] In its

---

[139] *See id.* at 1251.

[140] *See Estate of Propstra*, 680 F.2d at 1251. The court uses the term "unity of ownership principle." This seems have the same meaning as "family attribution." *See id* at 1251 n.4.

[141] *See id.*

[142] *See id.*

[143] *See Estate of Propstra*, 680 F.2d at 1251. The court refers to sections 267, 318 and 544 of the Internal Revenue Code dealing with income taxation not estate taxes. *See id.*

[144] *See id.*

[145] *See id.* at 1252.

[146] *See* Estate of Andrews v. United States, 79 T.C. 938 (1982); and Estate of Lee v. Commissioner, 69 T.C. 938 (1982).

stead, the IRS issued Revenue Ruling 93-12, which states that family relationships will not be considered when valuing gifts of stock in closely held corporations.[148]

3. Estate of Bonner v. United States – An Analysis of the Special Rules for Qualified Terminable Interest Property Trusts

In *Estate of Bonner v. United States*,[149] the United States Court of Appeals for the Fifth Circuit stated a rule regarding the availability of discounts on QTIP property.[150] The *Bonner* court held that, for valuation purposes, QTIP property is not merged with other property owned by the decedent.[151] Specifically, the court held that an estate could take a valuation discount on a decedent's estate tax return even though a portion of the decedent's property was held in a trust and the remainder owned outright.[152] In so holding, the court focused on the fact that the decedent, who held only an income interest in a QTIP trust, lacked control over the final disposition of the property.[153]

Mr. Bonner died in 1989 owning a 62.5% undivided interest in a ranch located in Texas.[154] He also owned in fee simple a fifty percent undivided community property interest in real property located in New Mexico and a fifty percent undivided community property interest in a pleasure boat.[155] The remaining 37.5% interest in the ranch and the other fifty percent interest in both the New Mexico property and boat was owned

---

[147] *See* Rev. Rul. 81-253, 1981-2 C.B. 187.

[148] See Revenue Ruling 93-12, 1993-1 C.B. 202. In determining the value of a gift of a minority block of stock in a closely-held corporation, the block should be valued for gift tax purposes without regard to the family relationship of the donee to other shareholders. *See id.*

[149] 84 F.3d 196 (5th Cir. 1996).

[150] *See id.* at 198.

[151] *See id.*

[152] *See id.* at 197.

[153] *See id.* at 198.

[154] *See Estate of Bonner*, 84 F.3d at 197.

[155] *See id.*

by a trust established by the will of his predeceased wife.[156] The trust was a QTIP trust under I.R.C. section 2056(b)(7)[157] and thus was not subject to estate tax upon the death of the wife.[158] Rather, the court held that it was included in the taxable estate of the husband as the surviving spouse.[159] Consequently, Mr. Bonner's taxable estate included one hundred percent of the undivided interests in the three properties.[160]

In calculating the estate tax to be assessed, however, the estate took a forty-five percent discount based on the decedent's fractional undivided interest.[161] The representative of the estate argued that the decedent owned only a portion of the property; the other portion was owned by the QTIP trust and was only included in the taxable estate so that it would not escape taxation.[162] The government, on the other hand, argued against this discount, claiming that the interests held by the QTIP trust and the interest held by the husband merged at the time of death, thereby resulting in complete ownership of the property.[163]

Relying on its decision in *Bright*, the Fifth Circuit held that QTIP property is not merged with other property owned by the decedent.[164] Instead, QTIP property must be valued separately from all other property.[165] The proper value then is the value at which that separate property would change hands between a willing buyer and a willing seller.[166] The court analyzed the hypothetical seller rule and found that family attribution,

---

[156] *See id.* Ms. Bonner died in 1986. *See id.*

[157] *See supra* note 30 and accompanying text.

[158] *See Estate of Bonner*, 84 F.3d at 197.

[159] *See id.*

[160] *See id.*

[161] *See id.*

[162] *See id.*

[163] *See Estate of Bonner*, 84 F.3d at 198.

[164] *See id.*

[165] *See id.*

[166] *See id.*

which relies on the identity of the seller as the legatee, cannot control the value of the asset because the valuation is a measure of the interest that is held at the moment of death, not the interest held by the decedent before death or the legatee after death.[167]

The *Bonner* court also held that the estate of a decedent should be taxed on only those assets whose disposition the decedent directs and controls.[168] In *Bonner*, the predeceased wife controlled the disposition of the property from the grave by the use of the trust.[169] While the husband was entitled to the income for his life, the wife ultimately chose the final recipients of the property.[170] Neither the husband nor the estate had any control over the disposition even though the husband's estate was required to pay the tax on the property.[171] This lack of control gives rise to a fractional interest discount.[172]

After *Bonner* and Revenue Ruling 93-12, the question of family aggregation appears to be settled and property held in trust will be valued independently of other property held by the decedent or by the beneficiaries.

III. FACTS OF *NOWELL V. COMMISSIONER*

During their marriage, Mr. and Ms. Nowell owned and acquired substantial interests in securities and real estate.[173] On April 20, 1990, Mr. Nowell formed the A.L. Nowell Trust and funded it with his community property interest in one-half of

---

[167] *See id.*

[168] *See Estate of Bonner*, 84 F.3d at 199.

[169] *See id.*

[170] *See id.*

[171] *See id.* at 198. Some QTIP trusts give the beneficiary a power of appointment over the assets. This was not the case in the Bonner trust. It is not clear whether the court would have allowed a discount if the husband had this control. *See id.*

[172] *See Estate of Bonner*, 84 F.3d at 199.

[173] *See* Nowell v. Commissioner, 77 T.C.M. (CCH) 1239, 1240 (1999).

the securities and real estate.[174] Upon his death on April 26, 1990, the trust property was transferred into three separate trusts: two Qualified Terminable Interest Property Trusts ("QTIP trusts")[175] and a trust entitled The Decedent's Trust.[176] The income generated by the property in the QTIP trusts passed to Ms. Nowell for her life with the remainder to be distributed to the heirs selected by Mr. Nowell.[177] David Prechel ("Mr. Prechel") and Diane Prechel ("Ms. Prechel"), Ms. Nowell's grandchildren from a prior marriage, were these remainder beneficiaries.[178] The trust named Ms. Nowell and Mr. Prechel as cotrustees.[179]

Six days before Mr. Nowell's death, Ms. Nowell formed her own revocable trust, the Ethel S. Nowell Trust, with her own community property interest.[180] Mr. Prechel and Ms. Prechel were the remainder beneficiaries of this trust as well.[181]

In 1991, Ms. Nowell and Mr. Prechel formed two limited partnerships, Prechel Farms Limited Partnership (PFLP) and the ESN Group Limited Partnership (ESNGLP), both funded by the assets of Ms. Nowell's revocable trust, the QTIP trusts and The Decedent's Trust.[182] The partnership agreements for both partnerships provided that no assignee of a limited part-

---

[174] *See id.* at 1240. Community property states require community property assets, as opposed to separate property, to be distributed equally between the parties or the party's estate on the death of a party or the dissolution of the marriage. All assets, except property acquired by gift, bequest, device or descent, generally are community property if the asset is acquired during marriage. *See* JESSE DUKEMINIER AND STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 472 (6th ed. 2000).

[175] One of the QTIP Trusts was an exempt trust and one was non-exempt. A discussion of the distinction is beyond the scope of this note. See *supra* notes 15 – 172 and accompanying text.

[176] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1240.

[177] *See id.*

[178] *See id.*

[179] *See id.*

[180] *See id.* at 1240.

[181] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1241.

[182] *See id.*

nership interest would become a limited partner unless the general partners consented to the assignee's admission as a limited partner.[183]

The following charts indicate the pre-discounted value of property contributed to the partnerships and the various ownership interests therein.[184]

---

[183] *See id.* at 1243. The distinction between an assignee and a partner is important because, in general, an assignee cannot exercise the normal rights of a partner. An assignee has only the right to distribution of income from the partnership. An assignee cannot interfere in the management of the business or require any information or account of partnership transactions. 59A AM. JUR. 2d *Partnerships* § 506 (1987).

[184] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1240.

Prechel Farms
Limited Partnership

Partners	Value of Contributed Property	Interest in Profit and Loss	Type of Interest
Ethel S. Nowell Trust	$1,386,500	60.41%	Limited
A. L. Nowell Decedent's Trust	$300,000	13.07%	Limited
A. L. Nowell QTIP Trust - 1	$408,000	17.78%	General
A. L. Nowell QTIP Trust - 2	$200,000	8.72%	Limited
David Prechel	$500	0.02%	General
Total	$2,295,000	100%	

ESN Group
Limited Partnership

Partners	Value of Contributed Property	Interest in Profit and Loss	Type of Interest
Ethel S. Nowell Trust	$75,000	13.04%	Limited
A. L. Nowell Decedent's Trust	$300,000	52.17%	General
A. L Nowell QTIP Trust - 2	$200,000	34.79%	Limited
Total	$575,000	100%	

Upon Ms. Nowell's death in 1992, by the terms of the various trusts, the 99.98% interest in PFLP not owned by Mr. Prechel passed to him and all interests in the ESNGLP passed to Ms. Prechel.[185] The value of these transfers were discounted at fifty or sixty-five percent on Ms. Nowell's estate tax return to account for lack of control and lack of marketability.[186]

The following chart lists the values reported on the federal estate tax return and the discounts claimed.[187]

Partner	Type of Interest	Value of Property Before Discounts	Value Claimed on Return	Discount
PFLP in Ethel S. Nowell Trust	Limited	$851,714	$298,100	65%
ESNGLP in Ethel S. Nowell Trust	Limited	$63,800	$31,900	50%
PFLP in QTIP Trust - 1	General	$250,600	$125,300	50%
PFLP in QTIP Trust - 2	Limited	$122,857	$43,000	65%
ESNGLP in QTIP Trust - 2	Limited	$170,000	$85,000	50%
		$1,458,971	$583,300	

[185] *See id.* at 1241.

[186] *See id.*

[187] *See id.* The property in The Decedent's Trust was not included in the gross estate of Ms. Nowell, probably because it was a credit shelter or bypass trust. Unlike QTIP trusts, credit protection trusts are not included in the estate of a decedent who holds only a life interest in the property. *See* Esperti, *supra* note 15, at 116.

IV. PROCEDURAL HISTORY

The IRS challenged these discounts and determined that the value of the Ethel S. Nowell Trust interests should be increased by $577,300 and the value of the QTIP trusts should be increased by $272,404.[188] These adjustments, along with an adjustment for a small income tax refund, resulted in a deficiency assessment and an additional $342,688 in estate taxes.[189]

Mr. Prechel, as the personal representative for Ms. Nowell's estate, brought this action in United States Tax Court to have the deficiency assessment reversed.[190] Both the IRS and Mr. Prechel moved for partial summary judgment and both motions were granted in part and denied in part.[191] The case was subsequently scheduled for trial regarding the amount of discounts allowed, but the IRS agreed that no additional tax would be assessed.[192] Thus, the ruling on motions for summary judgment concluded the case without a determination as to the actual dollar amount of the discounts that were allowed.[193]

V. COURT'S ANALYSIS

In *Nowell*, the tax court analyzed and decided two separate issues.[194] The first issue was whether the various partnership interests held by the estate should be valued independently of

[188] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1241.

[189] *See id.*

[190] *See id* at 1240.

[191] *See id* at 1243 - 1244. The opinion only covers the motions for summary judgment. *See id.*

[192] *See* Telephone Interview with Susan Smith, of Olsen-Smith Ltd., in Phoenix, Ariz. (October 8, 1999).

[193] *See* Telephone Interview with Susan Smith, of Olsen-Smith Ltd., in Phoenix, Ariz. (October 8, 1999).

[194] *See* Estate of Nowell v. Commissioner, 77 T.C.M. (CCH) 1239, 1242 (1999).

each other or whether they should be merged.[195] The court held that the interests should be valued separately.[196] The second issue was whether the interests that passed at death were partnership interests or assignee interests.[197] An assignee has the right to distribution of income but none of the normal rights of a partner.[198] The court examined state law and concluded that they were assignee interests.[199]

A. MERGER OF INTERESTS

The *Nowell* court, relying on its ruling *in Estate of Mellinger v. Commissioner*,[200] held that the interests should not be merged, but rather should be viewed as separate fractional interests held by the decedent at death.[201] In *Mellinger*, the decedent died owning 2,460,580 shares of publicly traded stock.[202] Her estate also included another 2,460,580 shares of the same stock held in a QTIP trust.[203] Relying on the rulings in *Bright*, *Propstra*, and *Bonner*, the *Mellinger* court found that property in a QTIP trust does not actually pass to or from the second decedent.[204] Thus, at no time does the second decedent

---

[195] *See id.*

[196] *See id.*

[197] *See id.* at 1242.

[198] *See* 59A AM. JUR. 2d *Partnerships* § 506 (1987).

[199] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243.

[200] 112 T.C. 26 (1999). Interestingly, the same judge decided both *Mellinger*, and *Nowell*. Both opinions were issued on the same day. The *Mellinger* court relied on the rulings in *Bright, Propstra,* and *Bonner* to reach its conclusion. *See id.*

[201] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1242. This ruling allowed the estate to value each partnership interest as if it stood alone. Each interest was thus allowed a discount for lack of control and lack of marketability, despite the fact that, taken as a whole, the pieces represented 99.98% of the underlying property. *See id.*

[202] *See Estate of Mellinger*, 112 T.C. at 27.

[203] *See id.* The QTIP trust was a testamentary trust created on the death of her husband. The stock contributed to the QTIP trust consisted of the husband's one-half interest in 4,921,160 shares held as community property by the husband and wife. *See id.*

[204] *See id.* at 35. QTIP property actually passes on the death of the first spouse to the designated heirs. The surviving spouse has only a life estate in the property. A

control or have power of distribution over the shares held in a QTIP trust.[205] Consequently, the *Mellinger* court refused to require the two blocks of stock aggregated for valuation purposes even though the combined ownership exceeded fifty percent of the corporation.[206]

The *Nowell* court reached the same conclusion after an additional analysis of Section 2044 of the I.R.C.[207] This section requires only that QTIP property be included in the estate, at its fair market value, for purposes of determining the transfer tax.[208] It does not require, however, that the decedent aggregate QTIP assets with other assets owned at death.[209] The court contrasted this with sections 267, 318, and 544, which specifically require aggregation of ownership for various income tax purposes.[210] The explicit nature of these sections illustrate that Congress could have provided for family aggregation, but did not.[211] By reverse implication then, because Congress was silent on the issue of family aggregation for QTIP property, Congress did not intend for QTIP property to be aggregated with other interests held by the decedent.[212]

To rebut this theory, the IRS urged that it is precisely because QTIP trust property is included in the taxable estate

---

life estate is extinguished on the death of the holder and normally is not included in the estate of the second decedent. QTIP property is an exception to this rule and is simply an election by the taxpayers to include the value of the property only in the estate of the second spouse to die. *See supra* notes 15 – 172 and accompanying text.

[205] *See Estate of Mellinger*, 112 T.C. at 36.

[206] *See id* at 33 - 35.

[207] *See* I.R.C. § 2044(a). "The value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying interest for life." *Id.* The code then goes on to say that this section applies to any property for which a QTIP election was made. *See id.*

[208] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1242.

[209] *See id.*

[210] *See id.* Sections 267, 318, and 544 generally require related parties to treat their separate holdings as a single block and restrict the ability to deduct losses resulting from transfers between related parties. I.R.C. §§ 267, 318, and 544 (1999).

[211] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1242.

[212] *See id.*

that Ms. Nowell should be treated as the owner of the property at her death for purposes of valuation.[213] The court found not only that the IRS had used the same line of reasoning in *Mellinger* but that the facts in *Nowell* bore enough similarity to warrant another rejection of the IRS's argument.[214]

B. ASSIGNEE OR PARTNERSHIP INTERESTS

In addressing the second issue, the court looked at the transfer of both general and limited partnership interests and afforded each a different treatment based on specific language in the partnership agreements.[215] The partnership agreements, executed by Ms. Nowell and Mr. Prechel for both Prechel Farms Limited Partnership and the ESN Group Limited Partnership, provided that an assignee of a limited partnership interest could not become a limited partner unless all general partners consented to the assignee's admission as a limited partner.[216] The IRS argued that this limitation should be disregarded because Mr. and Ms. Prechel, as assignees, held one hundred percent of the general partnership interests and, therefore, could admit themselves as partners.[217] The court relied on the Ninth Circuit's decision in *Propstra*, which holding that, "[t]he property to be valued for estate tax purposes is that which the decedent actually transfers at death rather than the interest held by the decedent before death, or that held by the legatee after death."[218] The court thus refused to consider the interests held by Mr. and Ms. Prechel after Ms.

[213] *See id.*

[214] *See id.*

[215] *See id.* at 1243.

[216] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1241. The distinction between an assignee and a partner is important because, in general, an assignee cannot exercise the normal rights of a partner. An assignee has only the right to distribution of income from the partnership. An assignee cannot interfere in the management of the business or require any information or account of partnership transactions. 59A AM. JUR. 2d *Partnerships* § 506 (1987).

[217] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243.

[218] *See id.* (citing Estate of Propstra v. United States, 680 F.2d 1248, 1251 (9th Cir. 1982)).

Nowell's death and stated that it must use the objective standard of a hypothetical buyer and seller to determine if the general partners would elect to admit the heirs as new partners, rather than the actual facts.[219] Under this objective standard the identity of the general partners cannot be assumed to be that of the assignees.[220]

The *Nowell* court next addressed the effect of state law on valuation of the limited partnership interests.[221] In determining the proper valuation, a court must first apply state law to determine the nature of the property and then apply federal law to determine the proper taxation of that property.[222] Under Arizona law,[223] a partner in a limited partnership may transfer to an assignee only the right to receive distributions of cash or other property.[224] He or she may not transfer the rights and powers of a partner, unless the partnership agreement allows for such a transfer.[225] The agreements for both the Prechel Farms Limited Partnership and the ESN Group Limited Partnership did not allow such a transfer. Rather, the agreements stated:

> A person who acquires one or more units but who is not admitted as a substituted limited partner . . . (1) shall be entitled only to allocations and disbursements with respect to such units in accordance with these articles, (2) shall have no right to any information or accounting of the affairs of the partnership, (3) shall not be entitled to inspect the books and records of the partnership, (4) shall not have any of the rights of a general partner or a

---

[219] *See id.*

[220] *See id.* This ruling allowed the estate to take further discounts on top of the discounts already allowed for lack of control and marketability. *See id.*

[221] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243.

[222] *See id.*

[223] Ms. Nowell died as a resident of Arizona. *See id* at 1240.

[224] *See id* at 1243.

[225] *See id.* Arizona law provides, "An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled." ARIZ. REV. STAT. § 29-340 (1999).

> limited partner under the act or these articles, but (5) shall be subject to the obligations of a unit holder under these articles...[226]

From this language the court concluded that the rights and powers of the limited partnership interests passed to Mr. and Ms. Prechel as assignee interests, and should be valued as such, rather than as full partnership interests.[227]

The court, however, refused to allow the same treatment for the assignment of the general partnership interest.[228] Originally, Mr. Prechel held a 0.02% general partnership interest in the Prechel Farms Limited Partnership.[229] At Ms. Nowell's death, Mr. Prechel inherited another 17.78 % of this general partnership interest, the rights of which were unrestricted under the partnership agreement.[230] Consequently, the court held that without the approval requirements associated with the limited partnership interests the general partnership interest automatically treated the beneficiary as a partner.[231] For this reason, the court held that the partnership interest should be valued as a general partnership interest.[232] Accordingly, the discount available on the interest should be reduced because

---

[226] *Estate of Nowell*, 77 T.C.M. (CCH) at1241.

[227] *See id.* at 1243. The opinion, however, offered no guidance on how the value should be determined.

[228] *See id.*

[229] *See id.* at1240.

[230] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1240. The agreement stated, "[a] transferee of units from a general partner hereunder shall be admitted as a general partner with respect to such units if (a) at the time of such transfer, such transferee is otherwise a general partner . . . ." *See id.* at 1241.

[231] *See id.* at 1243. This was an unfortunate decision for the beneficiary because he contributed only $500 for his less than one-percent general partnership interest. This small amount resulted in the loss of a significant discount on an interest with an original contribution value of $408,000. *See id.*

[232] *See id.* Unfortunately the published opinion again offers no guidance on the proper valuation of this interest.

general partners have management and control rights in the partnership.[233]

The court granted partial summary judgment to the estate of Ms. Nowell by finding the limited partnership interests passed to Mr. and Ms. Prechel as assignee interests.[234] However, the court also granted partial summary judgment to the IRS by finding the general partnership interests passed as full partnership interests.[235]

VI. CRITIQUE

The analysis in *Nowell* was correct, based on the Internal Revenue Code and case law. On the issue of family aggregation, courts have consistently held that, for valuation purposes, neither what the transferor held before the transfer nor what the recipient held after the transfer should be the basis for the valuation.[236] Rather, the calculation must only consider the interest that was actually transferred. This applies equally to the question of assignee interests versus partnership interests. Even though an assignee owns all of the outstanding partnership interests and can easily vote to convert his or her assignee interests to partnership interests, the IRS cannot be assumed he or she will do so. The court was correct in holding that when an interest in a limited partnership is transferred and the partnership agreement limits a transferee to an assignee interest, the other holdings of that transferee are not considered for valuing the interest transferred.

This result is a windfall for estate planners because it establishes a bright-line formula by which very large valuation discounts can be obtained using relatively simple estate planning techniques. These techniques allowed a husband and

---

[233] *See supra* notes 42 – 83 and accompanying text.

[234] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1243.

[235] *See id.* at 1240 - 1241.

[236] *See* Estate of Bonner v. Commissioner, 84 F.3d 196, 198 (5th Cir. 1996); Estate of Propstra v. Commissioner, 680 F.2d 1248, 1252 (9th Cir.1982); Estate of Bright v. Commissioner, 658 F.2d 999, 1006 (5th Cir. 1980).

wife, with an estate worth over two million dollars, to effectively hold property for their entire lives and pass the entire estate on to their intended heirs with reduced tax liability. Although the court is silent on the actual value of the taxable estate, the only property on which it reduced the valuation discount was the general partnership interest in PFLP held by the A. L. Nowell QTIP Trust-1.[237] Had the partners named the A. L. Nowell Decedent's trust as the only general partner in PFLP, the estate would have completely escaped estate tax liability because this trust was not included in the taxable estate of Ms. Nowell and the remaining assets were valued at less than the unified credit amount.

The key to using *Nowell* to develop a workable estate plan is the proper application of the state law under which the partnership is formed. Although only briefly mentioned in *Nowell*, section 2704(b) of the Internal Revenue Code provides that restrictions on transfers of an interest in partnerships between family members will be disregarded for valuation purposes unless the restriction is less than or equal to that imposed by state law.[238] In *Nowell*, the Arizona limited partnership law limited assignee rights to distribution of income only.[239] The partnership agreements in *Nowell* contained a

---

[237] *See* Estate of Nowell v. Commissioner, 77 T.C.M. (CCH) 1239, 1243 (1999). The court did not allow the general partnership interest held by the QTIP trust to be valued as an assignee interest. The discount claimed on the tax return was fifty percent or $125,300. Although the opinion does not state the discount that was allowed it can be presumed that some discount was allowed to account for the fractional interest (17.78 %) that this partner held. Using the full fifty percent discount claimed the total value of the estate was $583,300. The unified credit exempts the first $600,000 of assets from estate tax so even a significant reduction in the discount would result in a relatively small amount of asset value being subjected to tax. *See id.*

[238] *See* I.R.C. § 2704(b)

> (1) For purposes of this subtitle if – there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest. (2) . . . The term restriction shall not include – any restriction imposed, or required to be imposed, by any federal or state law. *Id.*

[239] ARIZ. REV. STAT. § 29-340 (West 1999). "An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled." *Id.*

similar restriction on assignee interests that was no greater than the state law.[240] This was critical in obtaining the maximum discount available. If the partnership agreement had contained a restriction on the rights of a holder of an interest greater than the controlling state law, the restriction would have been disregarded for valuation purposes and the discount would have been lost.

Given this ability to significantly reduce estate taxes, Congress may attempt to enact a prohibition on the use of valuation discounts. President Clinton's recent budget proposal contained such a restriction on the use of discounts on most family limited partnerships. The bill, however, would still have allowed their use in active trades or businesses.[241] The Republican-dominated House and Senate went to the opposite extreme when it sent to the President a bill that would have eliminated the estate tax entirely. President Clinton, as expected, vetoed the bill. Nevertheless, with the present tax reduction goals of the lawmakers, Congress probably will not place obstacles in the path of those who seek to reduce taxes by judicially-approved means. Thus, *Nowell's* use of valuation discounts appears to be a valid estate planning tool.

VII. CONCLUSION

The magnitude of the discounts allowed in *Nowell* and the clear formula for obtaining those discounts provides estate planners with a method to significantly reduce the estate tax burden on families. A family limited partnership and a series of QTIP trusts may be used to split up a family's assets so that the sum of the parts are valued at far less than the whole. Under the ruling in *Bonner*, and affirmed in *Nowell*, QTIP trusts effectively divide the assets into fractional interests that are not aggregated for valuation purposes, thus permitting the use of the fractional interest discounts to reduce their value for tax liabilities. The QTIP trusts can then be made limited

[240] *See Estate of Nowell*, 77 T.C.M. (CCH) at 1241.

[241] *See* Lee A. Sheppard, *The Need for Family Limited Partnership Legislation*, 82 TAX NOTES TODAY 1095, 1095 (1999).

partners in a limited partnership to which they contribute their assets. In this partnership, the one general partner has contributed very little and thus has a minimal interest. The bulk of the remaining assets are acquired from limited partners who, although they have contributed much, hold only limited partnership interests with no control over the business. This lack of control allows for the discount. Consequently, practitioners should draft partnership agreements so that any assignees acquire full limited partnership interests only on approval of the other partners. Thus, when transferees inherit an interest, that interest will be only an assignee interest for valuation purposes and the estate can obtain yet another discount. Under *Nowell*, this is permissible even if the transferees already own all the other outstanding interests in the partnership and can easily convert the assignee interest to a full partnership interest.

Russell Stanaland[*]

---

[*] Golden Gate University, School of Law, Class of 2001. I would like to thank Lisa Braly and the other editors who patiently reviewed my work and provided invaluable guidance.