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ESTATE TAX AGGREGATION THEORY: IRS CONTINUES ITS LOSING WAYS*

by

Martin H. Zern[†]

INTRODUCTION

The *cutting edge* of estate planning in recent years has been the promotion of stratagems to transfer property (e.g., marketable securities, real estate, a closely held business) at a reduced valuation, and consequently a reduced gift and/or estate tax burden. In general, the procedure used to realize this goal is to transfer fractional parts of the property, and/or to die owning only a fractional part. In some planning situations, a family limited partnership ("FLP") or, more currently, a family limited liability company ("FLLC") is formed to facilitate the transfer of fractional parts.¹ When utilizing a FLP, typically property will be transferred, usually by a parent or parents, in exchange for a small general partnership interest and larger limited partnership interests. When utilizing a FLLC, property is transferred for membership interests. Limited partnership interests in the FLP, or membership interests in the FLLC, are then gifted, perhaps over time, to family members, or trusts for their benefit.² The partnership or membership interests being gifted are valued independently of one another utilizing various discount valuation theories that have been advanced over the years. The basic concept is that, due to discounts, the sum of the value of the separate interests being transferred is less than the value of the entity as a whole (or the property held by such entity). The discount theories that have gained credibility are: lack of marketability, lack of control (minority interest), blockage (the inherent difficulty in selling large blocks of stock in one fell swoop), transferability restrictions, discount for dependence of the business on a key person and, recently, a discount for built-in capital gains tax.³ Moreover, the mere exchange of assets for partnership or membership interests arguably results in a reduction in value (i.e., the interests received are worth less than the transferred property) where restrictions are placed on the assignment of the interests. The concept that an *assignee* interest should be discounted will be considered later in this article.

In addition to valuation discounts that may be applicable in a gift situation, it is *important to be aware* that valuation discounting may be relevant where the property interest being valued is included in a person's gross estate. For instance, it would be appropriate to apply a minority discount (and perhaps an additional marketability

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discount) to a minority interest owned at death, even where the deceased had given away the majority interest during lifetime. Furthermore, as two new Tax Court cases discussed hereafter will illustrate, despite the fact that a controlling interest winds up being included in a person's gross estate, fractionalization and thus discounting of the overall interest is not precluded. As one of the new cases also illustrates, additional discounting may be appropriate at death where property interests have been converted into interests in a FLP or FLLC.

Although the Internal Revenue Service ("IRS") has challenged discounting, overall it has fared rather badly in the courts. As a result, the IRS seems to have accepted the concept of valuation discounting, albeit reluctantly, at least for the time being.⁴ Accordingly, when an estate or gift tax return is audited, the taxpayer is fairly well assured that some type of discount(s) will be allowed for fractional interests that have been transferred or that are held at death; it will be just a matter of negotiating the appropriate discount percentage to apply. If a settlement cannot be reached and the matter is litigated, it seems that the courts have a tendency to *cut the baby in half* or close thereto, frequently coming up with a valuation somewhere between the valuation proposed by the taxpayer's expert and that proposed by the IRS's expert. The writer of this article has heard that a shortage of trained IRS personnel in the estate and gift tax area due to budget cutbacks and turnover, and insufficient litigators adequately versed in the arcane estate and gift tax area, are the reasons for the IRS willingness to often compromise estate and gift tax cases involving discounts. Moreover, remedial legislation presently does not seem to be in the cards especially since there is a significant Congressional block advocating the complete repeal of the estate and gift tax laws. Accordingly, reducing estate and gift tax values through discounting in general, and in particular utilizing FLPs and FLLCs, seems to be an estate planning technique – the IRS might argue a scheme – that is alive and doing quite well.

While the IRS seems to have warily accepted the concept of discounting for the time being, it has from time-to-time attempted to limit its applicability by claiming that separate interests should be *aggregated* in determining value. It seems pretty clear now, however, that in determining the appropriate discounts, family attribution will not be considered. After losing numerous court battles, the IRS seems to have conceded that family attribution, although applicable in many areas of the income tax laws,⁵ is not relevant in the estate and gift tax area.⁶ The IRS, however, seems to have left open the door on family attribution by way of a *swing-vote* theory. For example, if the owner of 100% of the stock of a corporation gives away 30% to each of his three children, it could be argued that each 30% minority interest enhances the otherwise discounted value of the other 30% minority interests due to the fact that any sibling could join forces with another to control the corporation.⁷ In other words, the discount for each minority interest arguably should be reduced – but not eliminated – because each minority interest is a swing vote.

Despite conceding the family attribution issue, the IRS apparently has not given up on the aggregation theory, as two recent Tax Court decisions filed in 1999 demonstrate: *Estate of Mellinger*⁸ and *Estate of Nowell*.⁹

ESTATE OF MELLINGER

Factual Background

Harriet R. Mellinger (the “deceased”) died testate on April 18, 1993 (the “valuation date”). She was the widow of Frederick N. Mellinger, the founder of Frederick’s of Hollywood (“FOH”), a primarily California chain of specialty stores selling women’s lingerie. FOH was established in 1946 and had a reputation of being “slightly naughty,” but not offensive. In later years its lines became more conventional. At the time of the death of the deceased, FOH operated 206 stores in 39 states and conducted a mail order business through a subsidiary in all 50 states. Prior to Mr. Mellinger’s death, the decedent and he were husband and wife and owned, as community property, 4,921,160 of FOH. Such shares were held in a revocable *inter vivos* family trust managed by institutional trustees.

Upon Mr. Mellinger’s death, and pursuant to the terms of the family trust, one half of the stock was transmitted to an irrevocable marital trust for the benefit of the deceased during her lifetime. This trust met the qualifications for a Qualified Terminable Interest Property (“QTIP”) trust, the necessary election to treat it as such was made by the institutional co-trustees, and a marital deduction was claimed.¹⁰ The institutional trustees remained co-trustees of the QTIP trust. The terms of the QTIP trust provided for the decedent to receive a *qualified income interest for life*.¹¹ Upon her death, certain periodic and lump sum payments were to be made to the adult children of Mr. Mellinger and the deceased until age 65, certain periodic and lump sum payments were to be made to their grandchildren until age 30, and thereafter the balance in the trust was to be distributed to certain tax exempt charitable organizations. On the date of death of the deceased, the QTIP trust held 2,460,580 shares of FOH, which was 27.8671% of its issued and outstanding stock.

After Mr. Mellinger’s death, the deceased removed her on-half community share of the FOH stock from the family trust (i.e., 2,460,580 shares) and transferred it to a revocable trust she had established (the “Harriet Trust”). Consequently, this trust, with the same institutional co-trustees, also held 27.8671% of the issued and outstanding stock of FOH. Under the terms of this trust, upon the death of the decedent, the co-trustees were to sell the decedent’s residence and distribute the proceeds to her children. The balance of the assets were to be held by the trust and periodic distributions were to be made to her children and certain grandchildren. Upon the death of the children and grandchildren, the ultimate beneficiaries were certain charitable organizations.

The FOH stock held in both the QTIP trust and the Harriet Trust was included in the deceased’s gross estate¹² and was valued at \$4.79 per share. At the valuation date, the deceased also owned 50 shares of FOH outright. The institutional co-trustees hired two separate appraisal firms to value the stock and each firm valued the shares as *separate* 27.8671% interests in FOH. Both appraisers concluded that because of the size of each 27.8671% block relative to the trading volume of the stock, neither block could be sold in the public market without incurring a blockage discount. One appraiser felt the blockage

discount was 30% and valued the stock at \$4.85 per share, whereas the other appraiser felt a 31% blockage discount was appropriate and valued the stock at \$4.79 per share. The latter value was used for the estate tax return.

At the valuation date, FOH had one class of stock outstanding (unregistered) that traded on the New York Stock Exchange ("NYSE") at an average price of \$6.9375 per share.

In October 1993, roughly six months after the death of the deceased, there was a recapitalization of FOH. The effect of the recapitalization was to convert each three existing shares of FOH stock into one share of Common A (fully voting) and two shares of Common B (non-voting except as to limited issues). Further, the trusts were prohibited from selling the FOH stock for less than \$7.00 per share. In order to pay estate taxes, however some of the FOH stock was sold in January of 1994. Pursuant to a stock purchase plan, 357,143 Class A shares were sold by the Harriet Trust to an Employee Stock Ownership Plan (ESOP) established by FOH at \$4.20 per share. This was a 30% discount from the price of the stock on the NYSE. The ESOP relied on an appraiser for establishing the discount. In February of 1994, 29,500 Class B shares were sold on the NYSE at \$4.875 per share.

After negotiations spanning over a year, all of the stock of both trusts was sold in September of 1997, pursuant to a tender offer, at a price of \$6.90 per share. Stock held by other shareholders was also acquired at a price of \$7.75 per share.

IRS Position

Upon an audit of the estate a tax return of the deceased, the IRS determined that the stock held by the QTIP trust and the Harriet Trust should be *aggregated* in determining the overall value of the stock. In other words, the IRS asserted that the two blocks of stock together constituted over 55% of the issued and outstanding stock of the corporation, which was a controlling interest, and as such should be valued at a premium. Consequently, the IRS argued that the value for estate tax purposes was \$8.46 per share, and it determined a deficiency of \$10,574,983.

Tax Court's Holding

The Tax Court disagreed with the IRS position that the stock held by the two trusts should be aggregated, and thereby valued at a premium as a majority interest. The Tax Court, however, did not blindly accept the 30-31% discount advocated by the taxpayer's experts. It concluded that the FOH shares included in the deceased's gross estate should reflect a discount of 25% for lack of marketability, thus valuing the stock in FOH at \$5.2031 per share.

1. The Issue of Aggregation

In general, the value of a decedent's gross estate is determined by including property owned and property over which the decedent had certain control.¹³ Ownership includes property that is beneficially owned¹⁴ as well as property with respect to which the decedent owned, at time of death, a general power of appointment.¹⁵ Also included in the estate of a decedent is the value of property in which the decedent had a qualifying income interest for life and for which the decedent's predeceased spouse's estate took a marital deduction under the QTIP provisions.¹⁶ Consequently, property that is, so to speak, QTIP'd winds up being taxed in the estate of the Property included in the gross estate is included at its fair market value on the date of the decedent's death. In this context, fair market value is "the price that a willing buyer would pay to a willing seller, both persons having reasonable knowledge of all of the relevant facts and neither party being under a compulsion to buy or sell."¹⁷ The willing buyer or seller are hypothetical persons whose characteristics are not necessarily the same as the actual persons involved.¹⁸

Despite IRS challenges, for some time now, courts have allowed discounts to reflect lack of marketability and/or lack of control (minority interest) for fractional property interests gifted, or held at death, even where in the aggregate family members held overall control.¹⁹ The essence of the IRS argument that interests held by family members should be aggregated in determining values was founded on the theory that family cooperation would negate the fact that each interest held by family members was a minority interest, and that all of the interests of sold would be sold together. After losing numerous cases involving the family attribution issue, notably *Estate of Bright*,²⁰ a 1981 decision of the Fifth Circuit, and *Propstra*,²¹ a 1982 decision of the Ninth Circuit, the IRS ultimately conceded that for *both* estate and gift tax purposes it would not contest discounts solely because an entity is controlled by members of a family.²²

In *Propstra*, the decedent and his wife had owned real estate as community property. State law provided that death of a spouse dissolved the community, that upon death the community is divided equally, that each spouse can exercise testamentary disposition over his or her half, and that as a consequence only the decedent's half is included in his or her gross estate. Nevertheless, the IRS argued that the decedent's interest in the property should be valued together with the interest of his surviving spouse on the theory that the interest held by the estate would most likely be sold together with the interest of the survivor so that "the market value of the whole would be realized."²³ The executor though valued the decedent's share at a 15% discount.²⁴ The Court noted that Congress explicitly made family attribution applicable in other areas of the tax law.²⁵ Thus it reasoned that since Congress had not enacted explicit family attribution rules in the estate and gift tax arena, it was not up to the Court to apply such rules.

The IRS, however, argued that the facts in *Mellinger* were distinguishable because all of the property to be valued was included in the decedent's gross estate,

whereas only the one-half community interest was includable in *Propstra*. The FOH shares in the revocable Harriet trust were included in the gross estate of the decedent under I.R.C. § 2033 and the FOH shares in the QTIP trust were included under I.R.C. § 2044.²⁶ Consequently, since the decedent wound up with all of the FOH shares being included in her estate, which amounted to over 55% of the issued and outstanding stock, a clear majority interest, the IRS argued that the “shares should be valued at a premium rather than at a discount.”²⁷

The Tax Court then went on to analyze I.R.C. § 2044, which requires property in a QTIP trust to be included in the estate of the surviving spouse. The section was added to the Internal Revenue Code, together with I.R.C. § 2056(b)(7), in 1982.²⁸ The sections operate in tandem. The Congressional intent was to allow a marital deduction for property passing from the first spouse to die to the surviving spouse despite the fact that the property passing to the survivor was a *terminal interest* – i.e., the survivor’s interest in the property ended upon his or her death and it passed to whomever was designated to receive the remainder interest by the first spouse to die.²⁹ The *quid pro quo* of allowing a marital deduction for this type of terminal interest is the requirement that the property in the QTIP trust to be included in the gross estate of the surviving spouse, and that inclusion would be at the property value determined at the date of death of the survivor, or six months thereafter if the alternate valuation date were elected.³⁰ Thus the estate tax on the property placed in the QTIP trust, plus any growth in value less what has been consumed during the lifetime of the surviving spouse, is deferred until the death of the survivor.

Importantly, the Tax Court observed that although I.R.C. § 2044 requires QTIP property to be included in the estate of the survivor, “at no time did the decedent possess, control or have any power of disposition over the FOH shares in the QTIP trust.”³¹ Consequently, although the QTIP property had to be included in the deceased’s gross estate, she was not actually the owner of the property at her death. “Neither section 2044 nor the legislative history indicates that decedent should be treated as the owner of QTIP property....”³² “Section 2044 was designed to prevent QTIP property from escaping taxation by including it in the estate of the second spouse to die. There is, however, no indication that section 2044 mandated identical tax consequences as an outright transfer to the surviving spouse.”³³

The Tax Court also referred to *Estate of Bonner*,³⁴ a 1996 decision of the Fifth Circuit, which came to the same conclusion on similar facts. *Estate of Bonner* had followed the earlier decision of the Fifth Circuit in *Estate of Bright*, noted above. In *Bonner*, the Ninth Circuit opined that a “decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions”³⁵

As a final argument, which seems to have been a last gasp by the IRS, it asserted that I.R.C. § 2044 is a valuation section, rather than an inclusion section, comparing it to I.R.C. § 2040. This latter section mandates that the value of the gross estate shall include the value of *all* property held jointly with right of survivorship upon the death of the first

joint tenant to die except for the proportionate value of the property corresponding to the proportionate contribution, if any, to its acquisition by the survivor.³⁶ Thus despite the fractional interest owned by the deceased, the full value of the property is included in his or her gross estate, excluding only an amount proportionate to what the survivor contributed, if anything.³⁷ The court made short shrift of this contention, simply noting that I.R.C. § 2040 is applicable only to joint tenancy property, and that I.R.C. § 2044 contains no such directive. Since both sections were enacted as part of the same tax act, the court inferred there was no Congressional intention to apply a special valuation rule for property included in the estate of a decedent under I.R.C. § 2044.³⁸

2. The Issue of Valuation

Valuation has always been problematical for the courts: “[V]aluation is necessarily an approximation of judgement rather than mathematics.”³⁹ Although the regulations under the Internal Revenue Code and court decisions provide broad guidance, valuation is a question of fact requiring weighing all relevant evidence in each particular situation.⁴⁰ The fair market value of stock listed on an exchange is the mean between the highest and lowest selling prices on the valuation date.⁴¹ When a block of stock is so large, however, that it cannot be liquidated in a reasonable time without depressing its market value, a blockage discount may be applied.⁴² When a blockage discount is asserted, the burden of proving the correctness and amount of the discount is on the taxpayer.⁴³ The burden is one of persuasion requiring the taxpayer to prove its claim by a preponderance of the evidence.⁴⁴

When valuation is in issue, the IRS and the taxpayer must necessarily rely on expert testimony to determine the amount of the discount. Highly relevant is the qualification of the expert.⁴⁵ Nevertheless, the courts are not bound by an expert’s opinion of not in accord with the court’s judgment.⁴⁶ Where experts offer conflicting estimates, the court can evaluate the factors used by the experts to come to its own conclusion,⁴⁷ accept one opinion entirely,⁴⁸ use part of an opinion⁴⁹ or determine its own valuation based on the record.⁵⁰

In *Mellinger*, the parties stipulated that the undiscounted fair market value of the stock was \$6.9375 per share, the price at which it was trading on the NYSE on the valuation date. It was also stipulated that a marketability discount was to be applied if the court concluded, which it did, that the shares in the two trusts were not to be aggregated. The taxpayer was arguing for a 31% discount in this event, while the IRS contended that the discount should be only 15%. The intent of this article is not to explore the minutia involved in the art of appraising stock, but to simply present broadly the approaches that are sometimes taken.

A. Synthetic Put Option Analysis

When a block of stock represents several weeks of trading volume, the seller is exposed to a greater amount of market fluctuation. A way to reduce such risk is to buy put option contracts giving the seller the right to sell the shares at a fixed price over a set

period of time. This is called a *synthetic* analysis since FOH had no actual public market for any options in existence on the valuation date. One of the taxpayer's experts ("Kimball") in *Mellinger* originally estimated the expense of entering into such options for blocks of FOH stock using certain theoretical option pricing models, and came up with a 35% discount, or \$4.50 per share. On cross-examination, however, he admitted certain errors and readjusted his valuation to a discount range of 14.4% to 18%, or \$5.689 to \$5.9372 per share.⁵¹

B. Public Secondary Offering

Under this approach, Kimball reviewed various studies analyzing the costs of a secondary offering. Relevant in this regard was the risks of an unsuccessful secondary offering. Under this approach, he came up with a discount of about 26.5%, or \$5.10 per share. The court criticized this analysis noting that the expert did not compare the present case to transactions within the secondary offering studies that have similar characteristics, such as where the stock is traded, revenues, sales and similar factors. Instead he simply relied on the mean and median discounts of each study.⁵² The taxpayer asserted, however, that the expert relied very little on this approach and most heavily on the private placement analysis.⁵³

C. Private Placement Analysis

This analysis involves studies of restricted stock to analyze the private placement market. Kimball testified that various surveys reviewed by him indicated that for a publicly traded company an average discount was 35%. After considering other relevant facts under this approach, he concluded that in this case a discount of 32% was warranted, for a value of \$4.72 per share.

The taxpayer also offered the testimony of another expert ("Cotlier") to establish the appropriate discount. He testified that his review of studies showed there was a mean discount of 34.73% for lack of marketability, the discount being most sensitive to block size – the larger the block the larger the discount.

D. Operational and Market Analysis

Cotler also testified that to value the FOH stock properly, there must be an analysis of the company's operations and markets. In this regard he testified that at the valuation date, in 1992, FOH was experiencing negative financial performance, he testified that it would be difficult to sell a large block of the stock in the public market within a reasonable time at a price equal to the publicly traded common. He finally valued the FOH stock at a 31% discount, or \$4.79 per share.

E. IRS's Expert

The IRS's expert ("Fuller") testified that the proper marketability discount was between 10% and 17%. He asserted that there were three viable approaches to valuation:

(i) a registered secondary offering, (ii) a private placement, or (iii) a periodic sale subject to volume restrictions under SEC rule 144.⁵⁴ He testified that under the first approach, the discount should be between 10% and 13% and that under the third approach between 13% and 17%. He ultimately concluded, however, that the private placement analysis was the exclusive means to value the FOH stock since this was the most likely means of disposition. He testified that holding period restrictions were the primary reason for the discount. Fuller reviewed various studies on private placement offers. In contrast to the taxpayer's expert who considered only private placement block sales of restricted stock. He noted that private placement resulted in an average discount of 13.5%. Fuller then fine-tuned his analysis by selecting companies with market capitalization's similar to that of FOH. He ultimately concluded that the blockage discount should be 15%, or \$5.8969 per share.⁵⁵

The Tax Court rejected the IRS's and Fuller's approach noting that by relying on only one type of analysis "he rejected an entire body of restricted stock studies covering an extensive time span."⁵⁶ These other studies showed that the discount for restricted stock compared with freely tradable stock averaged 42%.

The taxpayer also asserted that comparable sales should be taken into account referring to the sale to the ESOP none months after the valuation date at a 30% discount and the sale by the Harriet Trust ten months after the valuation date at the market value at which the stock was trading on the NYSE on that day, \$4.875 per share. In this regard, the Tax Court observed that the sale to the ESOP was not a sale to an arms-length party. Furthermore, the sale took place after a re-capitalization and neither of the parties had presented any information as to how the re-capitalization affected value. The sale by the Harriet Trust was also quickly disregarded since that simply reflected the undiscounted value at that time.⁵⁷ The Tax Court did not consider the ultimate sale in September of 1997; apparently feeling it was too far removed from the valuation date.

Overall, however, the Tax Court was satisfied that "the respective discounts as determined by experts set the appropriate range from which we may determine the marketability discount," but took a swipe at the experts observing that "each expert excluded information that contradicted his result."⁵⁸ Cotler was patted on the back, the Court noting that he was the only one who addressed the specifics of FOH's financial situation in detail.

The Tax Court concluded that the discount claimed by the taxpayer was overstated while that claimed by the IRS was understated. Based on the entire record, the Court determined that the proper discount was 25%. Since the IRS had argued for a 15% discount and the taxpayer for 31%, the Tax Court did not quite split the baby in half.

ESTATE OF NOWELL

Factual Background

Ethel Nowell (the "deceased") died on December 22, 1992. The IRS determined a deficiency of \$342,688 in the estate tax due with respect to her estate. The decedent

was survived by Nancy Prechel ("Nancy"), David Prechel ("David") and Diane Prechel ("Diane"). Nancy was her only child from a prior marriage and Diane was her only granddaughter.⁵⁹

On April 20, 1990, the decedent's predeceased husband ("Mr. Nowell") had established the A.L. Nowell Trust, contributing his one-half community property interest in certain publicly traded securities and real estate and naming himself and David as co-trustees. Upon Mr. Nowell's death on April 26, 1990, the assets in the A. L. Nowell Trust were distributed into three trusts: (i) The Decedent's Trust, (ii) The Exempt QTIP trusts.⁶⁰ Decedent and David were the co-trustees of each trust.

Decedent had a qualifying income interest for life in the QTIP trusts and the remainder interests upon the decedent's death were to go to David outright and to Diane in trust. Mr. Nowell's executor had made the appropriate election to treat the property in the trusts as QTIP property and, accordingly, a marital deduction was taken for such property.⁶¹

Prior to January 18, 1991, the decedent's assets consisted of her one-half community property interest in the publicly traded securities and real estate. The assets were held in the Ethel S. Nowell Revocable Trust (the "Revocable Trust"). On this date, the decedent and David formed the Prechel Farms Limited Partnership (the "PFLP"). The general partnership interests were held by David and the Non-Exempt QTIP Trust, while the limited partnership interests were held by the Decedent's Trust, The Exempt QTIP Trust, and the Revocable Trust. The property contributed to the PFLP primarily consisted of certain assets held by the trusts.

Also on January 18, 1991, decedent and David formed the ESN Group Limited Partnership ("the ESNGLP"). Property was contributed to ESNGLP by the Revocable Trust; the Decedent's Trust and the Exempt QTIP Trust. The general partner was The Decedent's Trust, while the Revocable Trust and The Exempt QTIP Trust were limited partners. Upon the decedent's death, all partnership interests held by the Revocable Trust⁶² and the partnership interests held by the QTIP trusts.⁶³ The partnership interests were discounted for lack of marketability, lack of control and other factors. The discounts ranged from 50% to 65% of the net asset values of the partnership interests, specifically:

<u>Partnership Interest</u>	<u>Discount</u>
(a) PFLP interests in The Revocable Trust	65%
(b) ESNGLP interests in The Revocable Trust	50%
(c) PFLP interests in The Non-Exempt QTIP Trust	50%
(d) PFLP interests in The Exempt QTIP Trust	65%
(e) ESNGLP interests in The Exempt QTIP Trust	50%

The IRS determined that the partnership interests held by the Revocable Trust and the QTIP trusts should be merged for valuation purposes. This resulted in the

aforementioned estate tax deficiency of \$342,688. Specifically, the issues were (i) whether the partnership interests included in the gross estate under I.R.C. § 2038 (relating to the Revocable Trust) and the partnership interests included in the gross estate under I.R.C. § 2044 (relating to the QTIP trusts) should be *aggregated* for valuation purposes, and (ii) whether the interests in the two partnership interests. If the interests were aggregated, the IRS concluded that the estate should be taxed on 84% of the limited partnership interest in the PFLP, a 99.9% general partnership interest in the PFLP, and a 100% limited partnership interest in the ESNGLP, rather than on separate partnership interests owned by each of the trusts.

Tax Court's Holding

The Tax Court concluded that the partnership interests included in the gross estate under I.R.C. §§ 2038 and 2044 should be valued separately, and that the limited partnership interests should be valued as assignee interests. The general partnership interest passing to David, however, passed as a general partnership interest since he was a general partner prior to the death of the decedent.

Tax Court's Analysis

1. The Issue of Aggregation

Under I.R.C. § 2038, a decedent's gross estate includes the value of any property interest transferred by the decedent during lifetime where at the decedent's death the enjoyment of such property is subject to a power retained by the decedent to alter, amend, *revoke* or terminate the transfer, unless the transfer is for full consideration. As previously discussed in this article, I.R.C. § 2044 requires inclusion in the estate of the surviving spouse of the fair market value, determined at date of death of the surviving spouse, of QTIP'd property with respect to which the predeceased spouse took a marital deduction under I.R.C. § 2056(b)(7).

The first observation of the Tax Court was that it rejected IRS's aggregation approach in *Mellinger*, and found no reason to reach a different conclusion in this case. The Court reiterated what it said in *Mellinger*, namely that "at no time did decedent possess, control, or have any power over the ... shares in the QTIP trust,"⁶⁴ and concluded that "[t]hese principles are equally applicable to the case before us."⁶⁵ Although I.R.C. § 2044(c) treats QTIP property as "property passing from the decedent," the Court concluded that there was nothing in the section indicating that the decedent should be treated as the owner of the property for purposes of aggregation. Accordingly, the partnership interests in the Revocable Trust and the QTIP trusts were to be valued separately.⁶⁶

2. The Issue of Valuation as a Partnership Interests or Assignee Interests.

Once the Tax Court determined that the partnership interests were not to be aggregated for purposes of valuation, it then considered whether the partnership interests should be valued as partnership interests or only *assignee* interests.

Initially, the Tax Court observed that “[T]he property to be valued for estate tax purposes is that which the decedent actually transfers at his death rather than the interest held by the decedent before death, or that held by the legatee after death.”⁶⁷

The Tax Court determined that whether the limited partnership interests were to be valued as regular partnership interests or only as assignee interests depended upon the terms of the partnership agreement. Such agreement provided, in pertinent part, that a transferee of a limited partner was entitled only to allocations and distributions, but had (i) no right to any information or accounting of the affairs of the partnership, (ii) no right to inspect the books or records of the partnership, (iii) no rights of a general partner or limited partner under state law, but (iv) was subject to the obligations of a unit holder under other provisions of the partnership agreement. Another provision of the partnership agreement provided that a transferee of units could be admitted as a substitute limited partner only if all general partners consented to such admission. The agreement went on to provide that a transferee of a general partnership interest could become a general partner only if the transferee was otherwise a general partner or was approved as a general partner by a majority of the other general partners.

The IRS argued that the partnership interests passing to David remained partnership interests, and did not convert to mere assignee interests, since David was admitted “‘automatically’ as a general partner by virtue of his already being a partner in both partnerships.”⁶⁸ It also argued that since the trusts continued to hold some of the partnership interests after decedent’s death, substituting only Diane as a beneficiary, the interests remained partnership interests.⁶⁹

Referring to the state’s partnership law, the Tax Court observed that a partner could not confer to an assignee the rights of a partner unless so provided in the partnership agreement. With respect to the partnership agreement at hand, the Court concluded that the transferee of a limited partnership interest become only an assignee and not a substitute limited partner, unless the general partners consented to admission as a limited partner. However, since David was already a general partner in the PFLP, the Court found that the general partnership units in the PFLP transferred to him continued to be partnership units. Accordingly the Tax Court concluded that the limited partnership interests had to be valued as assignee interest, whereas the general partnership units in the PLLP transferred to David had to be valued as general partnership interests.⁷⁰ Although David and Diane could have been admitted as limited partners by a vote of a majority of the general partners, the Court opined that whether this would happen was a subjective factor that could not be considered “under the objective standard of the Hypothetical seller/buyer analysis.”⁷¹ NO general partnership interest passed to Diane.

Since the case was before the Tax Court on cross-motions for summary judgment, the taxpayer’s motion for summary judgment was granted in part and denied in part, and the IRS’s motion for summary judgment was granted in part and denied in part.

The Fundamental Question

The fundamental and difficult question before the Tax Court, was whether the partnership interests could be transferred as assignee interests due to circumstances existing *prior to* the death of he deceased or became assignee interests because of who wound up owning the interests after death. Arguably, a *pre-distribution transformation* of the nature of an asset should be taken into account.⁷² For instance, if a father owns 100% of the stock of a company, his estate should include the full value of the stock without any minority interest discounts despite the fact that he leaves 25% minority interests to each of his four children. In such scenario, there are no restrictions on the father's ownership at the time of his death and the minority ownership situation results because of the fact that four people wind up owning the stock after the father's death.⁷³ In *Nowell*, as noted, state law provided that a partner could not confer the rights of a partner to an assignee unless the partnership agreement provided otherwise. The partnership agreement in question did not provide otherwise, and in fact was consistent with state law, except that a general partnership interest could be transferred as a general partnership interest to someone who was already a general partner. Consequently, the *restrictions* in the partnership agreement on the transfer of interests existed prior to the death of the deceased. The Tax Court holding was thus a recognition that the restrictions on transfer were a *pre-distribution circumstance* that changed the very nature of what the deceased could transfer at death – namely, only assignee interests.

A Sophisticated Estate Plan

After the death of Mr. Nowell, the family apparently realized that the property in the QTIP trusts, formed pursuant to her husband's *inter vivos* trust, would be included in Mrs. Nowell's gross estate under I.R.C. § 2044. The family apparently also realized that he property in the Revocable Trust would be included in her estate under I.R.C. §2038. The property in the trusts consisted of marketable securities and real estate. Accordingly, to reduce the values, she and David formed two limited partnerships, PFLP and ESNGLP.⁷⁴ It should be noted that the partnerships were formed *approximately one year before Mrs. Nowell died*. Ultimately, David was to wind up with all of the partnership interests in PFLP and Diane was to wind up with all of the partnership interests in ESNGLP (in trust for her). Property was then contributed by Mrs. Nowell's revocable trust to the partnerships in exchange for partnership interests. Other property was transferred from the QTIP trusts to the partnerships in exchange for partnership interests. Thus, on Mrs. Nowell's death, the QTIP trusts held only (or perhaps primarily), partnership interests, limited and general. Her revocable trust likewise held only (or perhaps primarily) partnership interests, but only limited. The partnership interests were discounted by her estate for lack of marketability, lack of control and other factors. The discounts claimed, as previously noted, ranged from 50% to 65% of the actual net assets in stock and real estate held by the partnerships. The IRS obviously felt the discounts were unwarranted. Consequently, it tried to eliminate or at least reduce the discounts by asserting that the partnership interests held by Mrs. Nowell's revocable trust and the partnership interests held by the QTIP trust should be aggregated for purposes of valuation. If aggregated, the estate would be deemed to hold 84% of the limited

partnership interests in the PFLP, 100% of the limited partnership interests in ESNGLP and almost 99.9% of the general partnership interests in the PFLP (David had put in \$500 accounting for the .1% difference). The general partnership interest in ESNGLP was held by the Decedent's Trust, which seems to have been a credit shelter trust and thus not part of Mrs. Nowell's estate. On an aggregated basis, there apparently would be no discount for lack of control and a reduced discount, or perhaps none, for lack of marketability. The IRS's aggregation quest was, of course, unsuccessful.

Moreover, the Tax Court held that the limited partnership interests were to be valued as only assignee interests rather than substitute limited partnership interests due to the fact that the restrictions on their transfer were existent prior to the death of the deceased. As such, their value could be discounted even lower. The Tax Court, however, did not determine the actual discounts. The matter was just before the Court on cross motions for summary judgement: on the aggregation issue and the assignee issue. The exact discounts to be allowed will no doubt be, or have been, the subject of negotiations between the estate and the IRS. Of course, if no compromise has been or will be, reached, the matter may be back before the Tax Court.

CONCLUSION

It seems quite clear from the foregoing cases, that the Tax Court has a negative view of the IRS's aggregation theories. The Court has struck down this concept in the family situation and now has done so in another respect. In essence, the Tax Court held in *Mellinger* and *Nowell* that, for purposes of valuation, property interests included in a decedent's gross estate under either or both I.R.C. §§2033 or 2038 do not have to be aggregated with property interests included in a decedent's gross estate under I.R.C. § 2044. Whether the IRS will now surrender on its aggregation theory or fight further on appeal remains to be seen.

With respect to valuation *per se*, it has been and remains a battle of the experts. In this regard, the more highly qualified and experienced the expert, especially in testifying in court, the more likely will be the desired outcome. However, the work product of the expert should be carefully scrutinized and questioned. As the *Mellinger* case instructs, if a court finds an expert's work product lacking or contradictory, it can disregard it or accept only such parts as it deems satisfactory. Importantly, the expert should not rely solely on raw external statistics when valuing a company. There should be a thorough analysis of the particular company's operations and markets, along with the general and local economic conditions at the time.

The concept of discounting utilizing a FLP or FLLC seems to be well sanctioned by the courts. The discount for the transfer of a general partnership interest, limited partnership interest or membership interest will in part depend on whether the transferee can come onto the entity as a partner or member as the case may be, or only as an assignee of the interest. A mere assignee interest will be valued lower than a regular partnership or membership interest. What interest a transferee takes will depend upon the terms of the partnership or membership agreement and the provisions of local law. Since

most state laws defer to the terms of an agreement, the estate or gift tax outcome will largely depend upon how the agreement is drafted. Consequently, the *Nowell* case is an object lesson to draftsman of what should be done to assure that what is transferred is only an assignee interest, with a resultant lower value.

Finally, as *Nowell* instructs, it is *important* to recognize that the assignee discount that seems to be recognized for the transfer by gift of an interest in a FLP or FLLC seems equally to be recognized on the transfer of such an interest at death.

ENDNOTES

¹ A FLP or FLLC is often used because direct fractional transfers of property may not be feasible or advisable. For instance, a FLP or FLLC would be necessary where the property desired to be transferred at a discount is marketable securities. Although fractional parts of real estate may be transferred, this would subject the property to a partition action, which would not be the case of the property was held by a FLP or FLLC.

² In a FLP, the transferors usually keep control through ownership of a general partnership interest. In a FLLC, control may be exercised by having the transferor named as manager in the operating agreement. Note that there must be at least two transferors to set up a FLP since by definition a partnership requires at least two partners. Most states, including New York, permit a FLLC to be formed by one person. *See*, Treas. Reg. § 301.7701-3. All references herein to “Treas. Reg. §” are to U.S. Treasury Department regulations interpreting the Internal Revenue Code of 1986, as amended. To avoid a *substance over form* charge that what is being gifted is really undivided interests in the property transferred to the entity, it is advisable for their to be a hiatus (commentators have suggested at least 6 months) between the transfer of the property and the gifting of the partnership or membership interests.

³ *Eisenberg v. Commissioner*, 82 AFTR 2d 98-5757 (2nd Cir. 1998); *Estate of Davis*, 110 T.C. No. 35 (1998).

⁴ As a caveat, in order to better ward off an IRS challenge to the validity of a FLP or FLLC, there should be well-documented valid reasons, other than tax reduction, for forming the entity. There are numerous valid non-tax reasons for forming such an entity, which are beyond the scope of this paper.

⁵ *E.g.*, I.R.C. §§ 267 and 318. All references herein to “I.R.C. §” are to the Internal Revenue Code of 1986, as amended.

⁶ Rev. Rul. 93-12, 1993-1 CB 202; TAM 9449001 (1994).

⁷ Priv. L. Rul. 9436005 (1994) (citing *Estate of Winkler v. Comm.*, 57 T.C.M. 373 (1989)).

⁸ *Estate of Mellinger v. Commissioner*, 112 T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15 (1999).

⁹ Estate of Nowell v. Commissioner, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15 (1999).

¹⁰ I.R.C. § 2056(b)(7).

¹¹ A *qualifying income interest for life* is defined as one where the surviving spouse is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse during his or her lifetime. I.R.C. §2056(b)(7)(B)(ii).

¹² I.R.C. §§ 2033 and 2044.

¹³ I.R.C. § 2031.

¹⁴ Treas. Reg. § 20.2033-1(a).

¹⁵ I.R.C. § 2041.

¹⁶ I.R.C. §§ 2056(b)(7) and 2044.

¹⁷ Treas. Reg. § 20.2031-1(b) (as mentioned in 1965).

¹⁸ Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).

¹⁹ See, e.g., Estate v. Commissioner, 79 T.C. 938, 952-953 (1982) (minority and marketability discount for stock held by estate) and Estate of Piper v. Commissioner, 72 T.C. 1062 (1979) marketability discount allowed for gifted shares).

²⁰ Estate of Bright v. Commissioner, 658 F.2d 999 (5th Cir. 1981).

²¹ Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982). Also, see Estate of Andrews v. Commissioner, 79 T.C. 938 (1982).

²² Rev. Rul. 93-12, 1993-1 C.B. 202. Previously, the IRS position had been that, in the absence of family discord, a minority discount would not be allowed for transfers of stock in a corporation to family members where such members controlled the corporation. Riv. Rul. 81-253, 1981-2 C.B. 187.

²³ Propstra v. United States, 680 F.2d 1248, 1251 (9th Cir. 1982).

²⁴ *Id.*

²⁵ E.g., I.R.C. §§267 and 318.

²⁶ It is not clear why the IRS asserted that the assets in the revocable Harriet Trust were included in the deceased's gross estate under I.R.C. § 2033 rather than I.R.C. § 2038, which deals with revocable transfers. In this regard, *see* Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, discussed later in this article, where the revocable trust was included in the deceased's gross estate under I.R.C. § 2038. It may be speculated that the transfer to the Harriet Trust was deemed to come from the family trust (or from Mr. Mellinger who founded the company) thus making I.R.C. § 2038 technically inapplicable since this section requires a transfer by the decedent. In any event, it appears that if a person can revoke a trust, and dies holding that power, that person has a beneficial interest in the property in the trust requiring estate inclusion under I.R.C. §2033 of the property in the trust, despite the fact that the person did not transfer such property to the trust.

²⁷ Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *19

²⁸ Technical Corrections Act of 1982, Pub. L. 97-448, sec. 104(a)(1)(B), 96 Stat. 2365, 2380.

²⁹ In general, the marital deduction is not allowed if the interest passing to the surviving spouse is a life estate or other terminal interest. I.R.C. § 2056(b).

³⁰ I.R.C. § 2032 generally permits the value of the gross estate to be valued, if the executor so elects, at a value 6 months after the decedent's death.

³¹ Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *21. *Cf.* I.R.C. §§ 2035, 2036, 2038, 2041 (these sections require inclusion in the gross estate because the decedent controlled the assets sometime during his or her life).

³² Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS4, *23.

³³ *Id.* at *26.

³⁴ Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996).

³⁵ *Id.* at 199.

³⁶ *See, also*, Reg. § 20.2040-1 (1958).

³⁷ A different rule applies to property held jointly by a decedent and a spouse. Here, only one-half the value there of is included in the estate of the decedent. However, a marital deduction is allowed for such one-half since it passes to the survivor.

³⁸ Estate of Mellinger v. Commissioner, 112 T.C. No. 4m 1999 U.S. Tax Ct. LEXIS 4, *26

³⁹ Estate of Davis v. Commissioner, 110 T.C. 530, 540 (1988).

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- ⁴⁰ Ahamanson Found. v. United States, 674 F.2d 761, 769 (9th Cir. 1981).
- ⁴¹ Reg. § 20.2031-2(b)(1) (as amended in 1992).
- ⁴² Reg. § 20.2031-2(e) (as amended in 1992).
- ⁴³ Estate of Horne v. Commissioner, 720 F.2d 1114, 1117 (9th Cir. 1983), *affg.* 78 T.C. 728 (1982).
- ⁴⁴ Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir. 1975), *affg.* T.C. Memo. 1972-133.
- ⁴⁵ Parker v. Commissioner, 86 T.C. 547, 561 (1986).
- ⁴⁶ IT&S of Iowa v. Commissioner, 97 T.C. 496, 508 (1991).
- ⁴⁷ Casey v. Commissioner, 38 T.C. 357, 381 (1962).
- ⁴⁸ Buffalo Tool & Die Manufacturing Co. v. Commissioner, 74 T.C. 441, 452 (1980).
- ⁴⁹ Parker v. Commissioner, 86 T.C. 547, 561 (1986).
- ⁵⁰ Estate of Davis v. Commissioner, 110 T.C. 530, 538 (1998).
- ⁵¹ Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *30-32.
- ⁵² *Id.* at *32-33.
- ⁵³ *Id.*
- ⁵⁴ This approach was rejected by the expert since he concluded it would take seven years to liquidate the stock, which he concluded was inadequate.
- ⁵⁵ Estate of Mellinger v. Commissioner, 112 T.C. No. 4, 1999 U.S. Tax Ct. LEXIS 4, *37-39.
- ⁵⁶ *Id.* at *39.
- ⁵⁷ *Id.* at *40.
- ⁵⁸ *Id.* at *41.

⁵⁹ The case does not explain the nature of the relationship between Nancy, David and Diane, and one is thus left to speculate as to what it was. Were they necessarily husband, wife and daughter?

⁶⁰ The case does not explain the reason for the two QTIP trusts. One may speculate, however, that two trusts were set up for generation skipping tax purposes. David was the beneficiary of the non-exempt QTIP trust, while Diane, the granddaughter of the deceased, and thus a *skip person*, was the ultimate beneficiary of the exempt QTIP trust. Most likely, a sufficient amount of generation skipping tax exemption was allocated to the exempt QTIP trust so that it had an *inclusion ratio* of zero, which meant that upon the death of the deceased the resulting *taxable termination* would not result in any generation skipping tax.

⁶¹ I.R.C. § 2056(b)(7).

⁶² I.R.C. § 2038.

⁶³ I.R.C. § 2044.

⁶⁴ Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, *12.

⁶⁵ *Id.* at *13.

⁶⁶ *Id.* at *14.

⁶⁷ Estate of Nowell, T.C. Memo 1999-15 (1999); 1999 Tax Ct. Memo LEXIS 15, *14 (citing *Propstra v. United States*, 680 F.2d 1248, 1250 (9th Cir. 1982); *see, also*, *Ahmanson Foundation v. United States*, 674 F.2d 761, 769 (9th Cir. 1981).

⁶⁸ *Id.* at *15.

⁶⁹ *Id.*

⁷⁰ *Id.* *17.

⁷¹ *Id.* *18.

⁷² *See, e.g.*, *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981) and *United States v. Land*, 303 F.2d 170 (5th Cir. 1962).

⁷³ This may be contrasted with a situation where a father *gives* each of his four children 25% interests. Here, minority interests are being transferred and discounts would be appropriate since, as previously noted, the IRS has conceded the family attribution issue. *See*, TAM 9449001 (March 11, 1994).

⁷⁴ A transfer of an interest in a FLP or a FLLC owning real estate should be valued lower than a transfer of an undivided interest in the real estate itself since a partner or member has no right to bring a partition action.