View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by eGrove (Univ. of Mississippi)

University of Mississippi
eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

1-1-1999

Using family partnerships and refuting IRS challenges: AICPA FLP valuation discount white paper

American Institute of Certified Accountants;

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
American Institute of Certified Accountants;, "Using family partnerships and refuting IRS challenges: AICPA FLP valuation discount white paper" (1999). *Guides, Handbooks and Manuals*. 262.
https://egrove.olemiss.edu/aicpa_guides/262

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Guides, Handbooks and Manuals by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Using Family Partnerships and Refuting IRS Challenges

I. Introduction

This article intends to highlight the AICPA's position concerning the legitimate use of family partnerships. In particular, the AICPA takes exception with the Internal Revenue Service's ("Service's") refusal to recognize for transfer tax purposes the validity of many family partnership's under examination. In setting a framework for this discussion, we will examine the development of the family partnership as well as the major cases and laws which have focused on their transfer tax ramifications. We will then discuss the Service's current position, where it is appropriate and how it is being used to discourage practitioners from using the family partnership structure. Finally, we will rebut the technical basis for the Service's blanket challenge to family partnerships and suggest some guidelines for structuring family partnerships to minimize the potential for IRS challenge.

II. Historical Development of Family Partnerships

The use of family partnerships started back in the mid-1960s but really became popular in the mid-1970s. Prior to then, business and investment assets were held largely in corporations rather than partnerships. This was largely due to two factors. First, the law governing the formation and operation of corporations as compared to partnerships is far better understood by most attorneys. To a limited extent, this remains true today. Thus, absent other compelling reasons, a client's attorney typically urged the formation of a corporation rather than a partnership. Second, corporate income tax rates were significantly less than individual rates making the corporate structure the preferred structure for income tax deferral. Beginning in 1976, the spread between individual and corporate income tax rates narrowed markedly making partnerships and single level taxation far more attractive. Of equal significance, the 1986 Act brought the repeal of the General Utilities doctrine and eliminated the ability to liquidate a corporation tax free and avoid double level taxation. After 1986, the clearly preferred choice of entity for holding any business or investment became the limited partnership if for no other reason than income tax considerations. The adoption of the Uniform Limited Partnership Act by most states made the laws governing limited partnerships doing business in multiple states relatively similar and understandable. In addition, to their single level income taxation, limited partnerships are attractive entities because of:

A. limited liability for most partners, particularly if the sole general partner is a corporation;
B. very flexible equity structure;

C. both formation and liquidation is largely tax-free;
D. individual owners can be redeemed largely tax-free;
E. partnerships terms and provisions are flexible and can be changed by the partners as circumstances change;
F. limited partnerships serve as trust substitutes;
G. limited partnerships provide significant creditor protection. Limited partnership interests are seldom attached; they only provide creditors the limited right of an assignee;
H. limited partnership interests are attractive assets to gift since they are generally excluded from consideration in marital settlements and the ease with which they can be transferred;
I. use of limited partnerships avoid multi-state probate if real estate is owned in more than one jurisdiction;
J. avoid division of assets upon death of the holder of the partnership interest;
K. allows synergies in the management of the partnership's assets which are achievable only by consolidating financial wealth in one large common pot;
L. maintain family control of assets held by the partnership;
M. minimal capital requirement; and
N. partnerships are generally not subject to state franchise taxes.

There are numerous other reasons for combining and holding business and investment assets in a limited partnership.

One offsetting feature of a limited partnership to its holders is the fair market value of the underlying assets may be greater than the fair market value of the corresponding partnership interests. This is a clear negative to holding assets in partnership solution, particularly if the individual must rely on their personal balance in order to obtain credit. However, from a transfer tax perspective, the dampening of value is advantageous. This reduction in the value of the limited interests is largely due to the existence of marketability and minority interest discounts which exist when a limited partnership interest is valued in the marketplace. Since the standard for valuing property in general for both gift and estate tax purposes is the value that property would be sold between an arms-length buyer and seller, neither being under a compulsion to sell or buy, and both with a reasonable knowledge of the underlying facts. It is also critical to note that for transfer tax purposes fair market value is the price at which property would be sold to a hypothetical third party, not a strategic buyer or an individual who would gain voting control by the acquisition of the transferred interest. Moreover, there is nothing wrong with holding assets in a partnership rather than owning them directly, even though the former will almost in every instance, produce a lower transfer tax value. In addition to income tax and transfer tax considerations, partnerships possess numerous other nontax characteristics which make them ideal structures for holding wealth whether active or passive, and for transferring partial interests in that same wealth to other individuals.

Over the years, the Internal Revenue Service and the U.S. Treasury have long opposed the existence of large discounts in valuing limited partnership interests in the context of the transfers between family members. Throughout the '70s and '80s this opposition was focused on disallowing minority interest discounts in all transfers between family members where the family possessed effective control of the underlying limited partnership. The underlying theory espoused by the government was that all members of the family would act in concert; thus, each member of the family would be deemed to have the benefit of voting control with respect to the underlying limited partnership, thereby making each family transferor or transferee a controlling partner of the partnership. The government would deny most minority discounts with respect to the transfer of closely held limited partnership interests. This theory has been extensively litigated. Among the cases dealing with this issue are Estate of Bright v. U.S., 658 F.2d 999 (5th Cir., 1981); Estate of Andrews v. Comm., 79 TC 938 (1982); Ward v. Comm., 87 TC 78 (1986); Popstra v. U.S., 680 F.2d 1248 (9th Cir., 1982); Estate of Lee v. Comm., 69 TC 60 (1978), nonacq. 1980-2 CB 2. Finally, after repeatedly raising this argument and losing, the Service in Rev. Rul. 93-12, 1993-1 CB 202 acquiesced with the Courts' conclusion that minority discounts in addition to marketability discounts were applicable in the context of transfers of limited partnership interests between family members. Having conceded the existence of a minority discount in the context of an interfamily transfer, partitioners generally believed the Service was left with litigating the magnitude of such discount.

Concurrent with these valuation challenges, the Service was also attacking two uses of family limited partnerships which were tailored to cap or reduce the transfer tax of the senior generation. In Estate of John G. Boykin, 53 TCM 345 (1987), the government attempted to challenge the classic estate freeze[1] by arguing that the retention of deferred income interest is tantamount to the retention of a proportionate share of corporate income, thereby requiring inclusion of the entire business in the estate of holder of the preferred interest. (This technique was available to both partnerships and corporations.) The Court ruled in favor of the taxpayer and against the Service, noting that the rights of shareholders to receive dividends are established by the corporate documents that govern the rights of the shares under applicable state law. Shareholders were not entitled to any dividends except to the extent the company's board of directors approved the payment of dividends. Since the decedent possessed no voting control, the underlying value of the corporation was not included in the decedent's estate. The principle is equally applicable to limited partnerships. The Service also challenged the taxpayer's failure to exercise a conversion right from a noncumulative, relatively low yielding preferred to a common stock interest in Elizabeth W. Snyder, 93 TC 529 (1989). In this particular case, the taxpayer created a freeze structure with a noncumulative preferred interest which was convertible into common stock. While the corporation generated little cashflow, its underlying assets appreciated significantly. The government asserted that the taxpayer should have exercised their conversion

rights and exchanged the preferred interest for a common interest, and imputed a gift to the extent that having done so would have enhanced the value of the senior generation's equity position. The Court refused to extend the principles of Dickman v. U.S., 465 U.S. 30 (1984), and equate the failure to convert a noncurrently yielding preferred interest to a common equity interest when the children hold common equity interests to failing to charge interest on loans to your family. The Court rightly refused to substitute its judgment concerning whether to exercise a conversion right for the sound business judgment of the taxpayer and ruled against the Service.

In addition to attacking the freeze transaction, the Service also attempted to attack the use of lapsing liquidation rights. In Harrison v. Comm., 52 T.C.M. 1306 (1987), the government challenged a valuation of a taxpayer's limited partnership interest which as of the moment of death was illiquid, nonmarketable and could not be put back to the partnership. The taxpayer possessed a very large limited partnership interest and a small general partnership interest. The partnership was formed a few months prior to the taxpayer's death. While the taxpayer was alive, the taxpayer as a general partner could liquidate the partnership. However, under state law, upon death, the taxpayer ceased to be a general partner and could require only its general partnership interest to be redeemed by the partnership. While the taxpayer was alive, he could control the liquidation of both the general and limited partnership interest; however, at death, only the very small general partnership interest was liquid. The government argued that the liquidation rights and the related value which existed upon formation of the partnership but disappeared upon the taxpayer's death, should not escape taxation but should be included in the value of the taxpayer's estate. The Court disagreed with the Service and noted that the estate tax applies only to property whose value is determined at the moment of death and passes from the decedent's estate to its intended beneficiaries. In Harrison, the partnership interest was illiquid and nonmarketable at the moment of death.

III. Chapter 14

After a seemingly unbroken stream of judicial setbacks, Treasury and the Service decided to turn to legislation to cure what they perceived to be were abusive corporate and partnership structures from a transfer tax perspective. Congress, in 1990, enacted Chapter 14 of the Code, introducing §§ 2701-2704. Their structure and intent is relatively simple. Section 2701 is entitled, *Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships*, § 2702 is entitled *Special Valuation Rules in Case of Transfers of Interests in Trusts;* § 2703 is entitled, *Certain Rights and Restrictions Disregarded* and, § 2704 is entitled, *Treatment of Certain Lapsing Rights and Restrictions*. In general, the Senate Committee report describes the bill as modifying, "the valuation of specifically retained rights in corporations and partnerships; the valuation of split temporal interests in property; effect of buy/sell agreements and options upon value; and the transfer tax consequences of lapsing rights..." In other words, § 2701 is meant to repeal the results in both Boykin and Snyder.

Section 2703 was meant to deal with potential abuses involving buy/sell agreements and options and § 2704 unabashedly attempted to overturn the result in Harrison. What is of most significance is the legislative history is void of any discussion of cases dealing with minority or marketability discounts and, on more than one occasion, the legislative history specifically states that the bill is not intended to effect minority or other discounts available under existing law.

IV. The Service's Current Assault on Discounts Applicable to Limited Partnership Interests

Bolstered by their success in the Estate of Murphy v. Comm., TCM 1990-472 and Estate of Cidulka v. Comm., TCM 1996-149, the Service has effectively made a policy decision to challenge the validity of closely-held partnerships for transfer tax purposes. This has taken the form of potential litigation such as Estate of Elaine Smith White v. Comm., Docket #14412-97,[2] several letter rulings have been issued denying discounts for transfers of limited partnership interests, PLRs 9719006, 9723009, 9725002, 9725018, 9730004, 9735003, 9735043 and 9736004, and probably most troubling is a widespread audit program among gift tax agents where no discounts are being accepted with respect to the transfer of any closely-held partnership interest, with all meaningful negotiations are directed to the national office of the IRS. There are three broad theories for supporting the Service's current assault. The first is that the formation of a closely-held partnership by definition runs afoul of § 2703. Alternatively, the Service also argues that § 2704(b) will apply to the transfer. Finally, if Chapter 14 does not produce the desired result, there is a final appeal under the rationale of Estate of Murphy that the transfer of a partnership interest rather than the underlying asset is merely a device for the transfer of wealth to the natural objects of the transferor's bounty.

Section 2703 provides as follows:

> "(a) General Rule - for purposes of this subtitle, the value of any property shall be determined without regard to (1) any option, agreement or other right to acquire or use the property at a price less than the fair market value of the property, or (2) any restriction on the right to sell or use the property."

The Service interprets this Code section to say that the typical family partnership, in and of itself, is a restriction on the right of the owners to sell or use the value of the underlying property held by the partnership or, conversely, is an "agreement" limiting the ability of the partners to acquire or use the partnership's underlying property at a price less than the fair market value. In support of this position, the Service quotes the Senate Committee reports to the 1990 Act which created Chapter 14. In particular, in language related to § 2703, they rely on the following sentences; "these requirements apply to any restriction, however created. For example, they apply to restrictions explicit in a capital structure of the partnership or contained in a partnership agreement,

articles of incorporation or corporate bylaws or a shareholder's agreement." The Service makes the simple argument that to the extent a partner, whether limited or general, is precluded from accessing their proportionate of the underlying assets of the partnership or may only do so at a discount to the fair market value of the underlying assets the Service argues that § 2703 applies. They argue that unless the partnership can meet the requirements of 2703(b), the terms of the partnership is to be ignored for valuation purposes and the value of the partnership interest is merely that partner's proportionate share of the underlying assets.

Section 2703(b) provides that § 2703(a) shall not apply to any option agreement, right or restriction which meets three requirements: (1) it is a bonafide business arrangement, (2) it is not a device to transfer property to members of a decedent's family for less than full and adequate consideration or money's worth, and (3) its terms are comparable to similar arrangements entered into by person's in an arms-length transaction. The first two elements of 2703(b) were merely codification of existing law.

The third prong was added ostensibly to support the holding of St. Louis County Bank v. U.S., 647 F.2d 1207 (8th Cir. 1982). In most instances the taxpayer can never meet this third prong. The IRS claims that it is extremely unusual for taxpayers to transfer property into partnerships with unrelated parties in which their ability to sell, pledge, encumber or otherwise transfer the interest is absolutely prohibited. Nor do they believe that the vast majority of most agreements include a prohibition against the putting of a partnership interest back to the partnership. Even if such terms and provisions in partnership agreements exist in partnerships which are arms-length, the Service argues that such provisions are not similar arrangements. The Service states that in the context of the family partnership area, these partnerships contain the vast majority of the transferor's lifetime accumulation of assets and, thereby, the transferor irrevocably forfeits the exclusive rights to unilaterally decide to liquidate, exchange, gift presently received income and gains generated by the assets and to derive benefits from the present possession and enjoyment. The Service argues that persons who are not related do not transfer virtually all their wealth to a partnership under an agreement with unrelated parties that makes it impossible for them to reach those assets or the equivalent of those assets in money or money's worth. While people have been known to transfer a portion of their wealth to such investments with similar liquidation restrictions, nobody puts all of their wealth irrevocably under the control of unrelated persons. (I'm sure trusts companies would beg to differ.) The Service uses this as conclusive evidence that the taxpayer cannot meet the third prong of § 2703 (b).

The Service also argues that the taxpayer cannot meet the second prong; that the formation of the partnership is merely a device with which to transfer the value of the partnership's assets to the younger generation for less than full and adequate consideration. The Service cites declarations by taxpayers stating that one of the reasons for using a partnership is the fact that it makes it easy to

begin making gifts to their children and grandchildren. Therefore, the formation of the partnership was a device from the beginning for the purpose of transferring the donor's wealth to their natural beneficiaries. This argument makes little sense. As discussed earlier, one of the attractive features of the limited partnership structure was that children and grandchildren would be obtaining a relatively illiquid asset which did not necessarily produce significant cashflow. Most donors are particularly concerned about spoiling younger family members with large gifts of cash or other liquid assets. Converting such assets into an illiquid form prior to gifting is obviously desirable. Moreover, the partnership format is far more desirable for gifting purposes than transfers of partial interests in real estate or other business assets. It is impractical and costly to make small transfers of real estate or other assets which must be rerecorded upon each successive transfer.

In the event the Service loses under § 2703, it would then argue that § 2704 would apply in most instances, preventing most of the discount in the valuation of partnership interests. Section 2704, in general, addresses perceived abuses related to the existence of lapsing rights which reduce the transfer tax value of a partnership interest and certain restrictions on the partnership's ability to liquidate. Section 2704(a) attempts to reverse the Harrison decision. If there is a lapse of any voting or liquidation right in a corporation or partnership and the individual holding such right immediately before the lapse and members of such individual's family hold both before and after the lapse control the entity, then the lapse of the right shall be treated as a transfer by gift or a transfer includable in the gross estate of the decedent, whichever is applicable. Thus, if a partner had the ability to liquidate all or part of his or her interest during life, and upon that partner's death their ability to liquidate any portion of the partnership interest of that partner diminished, a lapse would occur. Arguably, this reversed the result in Harrison. Section 2704(a) does not apply to the lapse of a liquidation right under certain circumstances. Specifically, under Treas. Reg. § 25.2704-1(c)(B), "whether an interest can be liquidated immediately after the lapse is determined under the state law applicable to the entity, as modified by the governing instrument of the entity, but without regard to any restriction described in 2704(b)." The regulations define a lapse of a voting right or liquidation right as follows: "a lapse of voting right or liquidation right occurs at the time the presently exercisable right is eliminated." Generally, a transfer of an interest that results in the lapse of a liquidation right is not treated as a lapse if the rights with respect to the transferred interest are not restricted or eliminated. Treas. Reg. § 25.2704-1(c). Thus, the transfer of a minority interest in a corporation or partnership by the controlling shareholder or partner by definition is not a lapse of voting rights nor is it typically a lapse of liquidation rights as long as a general partnership interest is not being transferred and the transferor retains his ability to liquidate his remaining ownership interests.

Section 2704(b) was meant to address abusive restrictions which resulted in the "excessive" discounting of lifetime transfers of interest in a corporation or a partnership. In general, it provides that to the extent there has been a transfer

of an interest in a corporation or a partnership to a member of the transferor's family and the transferor and members of the transferor's family hold, both before and after the transfer, control of the entity, any applicable restriction may be disregarded in determining the value of the transferred interest. An applicable restriction is defined to mean "any restriction which limits the ability of a corporation or a partnership to liquidate and either lapses in whole or part after the transfer or could be removed in whole or part by the transferor or any member of the transferor's family acting either alone or collectively." Section 2704(b)(2). The Service also interprets the definition of an applicable restriction to include restrictions on a partner's ability to transfer their interest either to the partnership or others. The term applicable restriction does not include any commercially reasonable restriction which arises as a part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee or a member of the family of either, or to any restriction imposed or required to be imposed under federal or state law. Thus, in most jurisdictions in which the Uniform Limited Partnership Act serves as the model, the Service would take the position that in valuing a lifetime transfer of a limited partnership interest to a family member that any restriction on the partner's ability to put that interest back to the partnership is an applicable restriction and would be ignored for purposes of valuing that partnership interest for gift tax purposes. Most state laws provide that if the partnership agreement is silent concerning a partner's right to put their interest back to the partnership, that a partner has the right to put their interest to the partnership upon providing six months notice to that partnership. However, state laws vary as to partner rights. While a partner, under most states' law where the partnership agreement is silent, has a right to put their interest, it may only entitle the partner to an undivided interest in partnership assets or subject that partner to liability for damages caused to the partnership by exercising that right. Those corollary issues may justify significant valuation discounts even where a partner has the right to put their partnership interest.

Should it lose both arguments under §§ 2703 and 2704, then the Service has the fallback position that either the formation of the partnership itself is a device to transfer wealth to family members at a discounted value and should be properly includable in the decedent's gross estate as occurred in Estate of Schauerhamer v. Comm., T.C.M. 1997-242, or, alternatively, there was a gift to the younger generation upon formation of the partnership to the extent that the older generation received partnership interests worth less than the assets they contributed, albeit proportionate in value to the partnership interests received by all partners. The Service would argue that under Schauerhamer as well as Estate of Murphy that transfers of partnership interests in close proximity to death may be includable in the gross estate under § 2036 if they are either poorly implemented and ignored as legal entities (as occurred in the case of Schauerhamer) or occur so close to death that the partnership is merely a device for discounting the value of the decedent's taxable estate as occurred in the Estate of Murphy. The Service's argument is that because the creation and/or transfer of the partnership coincides so closely with the date of the

decedent's death that, for all practical purposes, the Service does not believe that the partnership was formed for any of the business purposes discussed earlier but was formed solely to reduce the ultimate transfer tax liability for the decedent. Accordingly, the Service asserts the assets should be included in the taxpayer's estate under § 2036.

Using these multi-layered arguments, the Service has aggressively audited numerous taxpayer's gift tax returns and threatened litigation in many instances. Moreover, through the use of published and unpublished letter rulings, the Service has attempted to dissuade only the most versed and skilled planners from using family partnerships for their clients. The ultimate impact of these policies has been to confuse taxpayers of more moderate means and curtail the use of the limited partnership to those individuals with the more sophisticated advisors. This has the unfortunate consequence of limiting the many benefits of family partnerships to only those clients willing and financially able to contest the IRS which, we are sure, is not the true intent of either Congress or the Service.

V. Rebuttal of the Service's Arguments Concerning Family Partnerships

The Service's initial position that under § 2703 the provisions of a partnership agreement can be ignored for purposes of valuing the transfer of a partnership interest in a closely-held partnership cannot be supported using traditional statutory construction. The Senate report made it clear that the Chapter 14 did not change the fundamental principles under §§ 2031 or 2511 for determining fair market value. Specifically, that committee report stated "the bill does not affect minority discounts or other discounts available under present law...." It continued, "the bill does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deductions, loss, and gain in the same proportion...." The Service may well argue that this language is contained in the portion of committee report that relates to § 2701 and, therefore, has no impact on § 2703. That, moreover, it should not be read out of context of the provision within which it is found. In general, we would agree. However, we would also note that the language quoted by the Service in support of their position is from the joint committee report related to restrictions covered in § 2704 and not § 2703 and, therefore, would have no relevance or bearing with regard to § 2703. Moreover, the language contained in the Senate committee report related to § 2703, which was not materially modified by the committee report, is titled "Buy/Sell" agreements. "The committee report discussing § 2703 then reads, "This bill provides that the value of property for transfer tax purposes is determined without regard to an option, agreement or other right to acquire or use the property at less than fair market value or any restriction on the right to sell or use such property, unless the option, agreement, right or restriction meet three requirements." It then discusses the three requirements which are a part of § 2703. The committee reports dealing with this section conclude with the statement, "the bill does not otherwise alter the requirements for giving weight to a buy/sell agreement." For example, it leaves intact existing rules requiring

that an agreement have lifetime applicability in order to be binding on death. It is clear that the committee report intends for § 2703 to address option agreements, traditional buy/sell agreements between family members, and similar agreements, and not partnership agreements.

The committee report is careful to note that in the context of an option or a buy/sell right with respect to a partnership interest or an interest in a corporation, that such restrictions or rights could be imbedded in the various documents relating to the governing of the entity. If such provisions are contained in a partnership agreement, the partnership is not ignored but merely that clause of the partnership might be ignored. Nowhere in the context of the committee report can it be imagined that Congress through the enactment of § 2703 intended to cause the existence of a partnership agreement to be disregarded for valuation purposes. Nor does it equate a partnership agreement to an option or buy/sell agreement. It is clear Congress intended § 2703 to clarify and reaffirm the reasoning of St. Louis County Bank and reject suggestions of other cases that the maintenance of family control standing alone assures the absence of a device to transfer wealth in the context of a traditional buy/sell agreement or variations thereon. Nothing more can be inferred.

There is no discussion anywhere in the legislative history of § 2703 that it was intended to override any other provision of the Code and, in particular, Code § 7701(a)(2). Code § 7701(a)(2) provides that for estate and gift tax purposes the term, partnership, includes "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, operation, or venture is carried on, and which is not, within the meaning of this title, a trust, or estate or corporation; and the term 'partner' includes a member of such a syndicate, group, pool, joint venture, or organization." Thus, neither § 7701(a)(2) or, for that matter, § 2703, suggest that a validly formed partnership under state law should be ignored for gift or estate tax purposes. If the partnership is recognized as validly formed for transfer tax purposes, then the property with which § 2703(a) must be making reference to is the transferred partnership interest and not the underlying property of the partnership. No other statutory construction makes sense particularly in the context with which Chapter 14 was enacted.

If through some perverse interpretation of the legislative history to § 2703 the courts determine § 2703 did indeed amend § 7701(a)(2), then for the partnership agreement not to be an agreement which restricts the owner's ability to acquire or use the underlying property at a price less than fair market value, the taxpayer must prove that the partnership agreement is (1) a bonafide business arrangement, (2) not a device to transfer property to members of the transferor's family for less than an adequate consideration, and (3) at the time the partnership is formed, the terms of the partnership are comparable to similar arrangements entered into by persons in an arms-length transaction. As long as the partners respect the terms of the partnership, then the partnership should meet the bonafide business arrangement requirement.

As stated at the beginning of this paper, there are numerous sound business reasons for forming a partnership as well as the fact that it is clearly the most income tax efficient structure for owning an investment or business. It is even the default entity under § 7701(a)(2) and § 761 for situations when more than one legal entity join together to form another entity. Thus, under the Code there is a presumption that joint activities will be in the form of a partnership. Congress obviously intended that partnerships be widely used and recognized for tax purposes.

Under the second prong to the exception to § 2703, entering into the partnership agreement by the transferor must be shown not to be a device to transfer the property he contributed to the partnership to a family member for less than full and adequate consideration. Thus, the taxpayer must prove that either the drafting of the partnership agreement is not a device for transferring wealth or that the transferor's family did not receive the full value of the underlying assets. The device test is not new and has been argued consistently by the Service under § 2031 in Estate of Bischoff v. Comm. 69 TC 32 (1977) as well as in Harrison v. Comm. and Estate of McClendon v. Comm., 66 TCM 946 (1993). The Courts in each of these decisions determined that transfer restrictions contained in partnership interests are not, in and of themselves, devices artificially depressing the value of the transferred partnership interest. The device test is fundamentally a question of whether transfer tax savings was the primary motivation for forming the family partnership or were there other valid income tax and/or business purposes for forming the partnership which at least equal or exceed the transfer tax benefits of the partnership.

The facts of St. Louis County Bank were extreme. The buy/sell agreement restrictions were ignored by the taxpayer's family with respect to lifetime transfers to family members. Moreover, the buy/sell formula in the St. Louis County Bank resulted in an unrealistic valuation of zero of the underlying asset. Such extreme valuation formulas cannot be considered a typical business arrangement. Unrealistically low valuation formulas create a strong implication that the buy/sell agreement is a device to transfer wealth to the decedent's family. With respect to most family partnerships, neither of these extreme sets of facts are present. The key lesson of the St. Louis County Bank's opinion was "the District Court concluded that the existence of a valid business purpose necessarily excluded the possibility that the agreement was a tax- avoidance testamentary device. We disagree. The fact of a valid business purpose could, in some circumstances, completely negate the alleged existence of a tax avoidance testamentary device as a matter of law, but those circumstances are not necessarily presented here." The extreme valuation formula created a clear implication in the Court's mind that the buy/sell agreement was a device to transfer wealth to the decedent's family. In a typical family partnership, that kind of fact pattern is simply not present. As long as the partnership remains in existence for some period of time following either the death of the decedent or transfer of the partnership interest, then the partnership agreement, in and of itself, should not be considered a device. The maintenance of partnership for

an extended period of time supports the taxpayer's position that the partnership was formed for valid business purposes in addition to the favorable tax attributes.

Although not needed, the second part of § 2703(b)(2) could also be met by most taxpayers. In most instances, what a transferee receives either through a lifetime transfer or through a taxpayer's estate is not a right of a limited partner or a general partner to receive the underlying asset value but is a right as an assignee to the partnership interest. An assignee does not automatically become a partner under most state law and most partnership agreements until the partners of the partnership expressly admit the assignee as a partner to the partnership. Typically, such admission can be withheld for any reason. Thus, it would be impossible for the Service to argue that the underlying asset value has been transferred to the transferor's family because all they received were the rights of an assignee in most instances. The value of those rights, in many cases, may be less than what the transferor had prior to the transfer.

The final prong to the exception to § 2703 requires that the taxpayer show that the restrictions and terms of the partnership agreement are comparable to similar arrangements entered into by persons in an arms-length transaction. The regulations define a similar arrangement as one that could have been obtained in an arms-length among unrelated parties in the same business dealing with each other at arms-length. A right or restriction is considered a bargained for restriction if it conforms to the general practice of unrelated parties under negotiated agreements in the same business. Limitations on the ability of a transferee to automatically be admitted to a partnership are found in most partnership agreements and are the default provisions under most state laws. Moreover, limitations on a partner's ability to sell or redeem their partnership interest are not unusual any time multiple entities join together in a common endeavor. This is necessary to protect all partners from the costs of maintaining high levels of liquidity or the inopportune sale of illiquid assets. However, the trend in many states is to restrict the ability of a limited partner to put their interest as the default provision under state law. In those states it cannot be argued that restrictions prohibiting the exercise of such put rights are not typical or common. Even if such limitations were not deemed to be present in similar arrangements among unrelated parties, then the partnership agreement itself would not be ignored in its entirety but merely that clause of the partnership agreement. The property being transferred is still a partnership interest. To the extent that the partnership has other restrictions or limitations on a partner's ability to monetize their interest, those terms would still have a depressing impact on the value of that interest. The asset to which § 2703 is to apply, if at all, is still a partnership interest because economically and legally that is all that the recipient received. Its valuation at worst will be determined under the § 2703 modified partnership agreement.

In any event, withdrawal rights and most other partner rights under most state laws are limited to limited partners and are not extended to assignees. Thus, the transferee in most instances would not have the right to put their interest under

state law until they became a partner. As previously discussed, the right to become a partner is not mandated under state law and is problematic at best. In conclusion with respect to § 2703, it should not be construed as to apply to modify the definition of a partnership for transfer tax purposes under § 7701(a)(2) but should be interpreted in the context of buy/sell arrangements and option agreements. Even if § 2703 were to be applied to every partnership agreement per se, most family partnerships should be able to meet the three pronged requirements under 2703(b) to be excepted from the application of § 2703(a).

The applicability of § 2704(a) and (b) is also not likely or appropriate. In the context of 2704, the issue is whether there has been a lapse of any liquidation or voting right held by the decedent. This arguably arises if the decedent holds either a limited partnership interest or both a general and limited partnership interest. As discussed previously, under most state laws the transferee of a general partnership interest or a limited partnership interest only receives the rights of an assignee and is not elevated to those of a partner absent the remaining partners consenting to the assignee being admitted to the partnership. Therefore, in the context of the death of a limited partner is there a lapse associated with that limited partnership interest which occurs when the successor of that limited partnership interest only has the rights of an assignee? Arguably, there has been some lapse but as a practical matter, there has been no lapse of any measurable value because under the willing buyer/willing seller test of Treas. Reg. § 20.2031-1(b), a third party hypothetical acquirer of such interest would realize that he was only obtaining the rights with respect to that partnership interest as an assignee and not as a limited partner. Therefore, the valuation of a typical limited partnership interest both before and after any transfer should not be materially different and should approximate the value of an assignee interest. Hence, no lapse in value occurs, merely due to a transfer even at death.

In the context of the situation where the decedent has both a general and limited partnership interests, the issue is a little more complex. As previously noted, § 2704(a) does not apply to a lapse of a liquidation right where the lapse would be disregarded under § 2704(b). Under Treas. Reg. 25.2704-1(c)(2)(b), "whether an interest can be liquidated immediately after the lapse is determined under the state law generally applicable to the entity, as modified by the governing instruments of the entity, but without regard to any restriction described in § 2704(b)." Thus, under most state laws, a limited partnership interest cannot be liquidated except as provided under state law and only assignee rights can be transferred. Most general partnership interests can be redeemed under state law by the partnership; however, that would not terminate the partnership unless the decedent was the sole general partner of the partnership. Thus, in most instances, § 2704(a) would once more have only limited applicability. It arguably would apply only to the extent a partner lost the ability to put their general partnership interest, but would still have no impact on the valuation of their limited partnership interest.

With respect to most pro rata limited partnerships, § 2704(b)is not applicable to transfers of limited partnership interests to a family member for a number of reasons. First, an applicable restriction is defined under the Code to mean "any restriction (a) which limits the ability of the corporation or partnership to liquidate and (b) with respect to which either of the following applies, (1) the restriction lapses in whole or in part after the transfer of the interest or (2) the transferor or a member of the transferor's family either alone or collectively has the right to ask for the removal in whole or part of the restriction." § 2704(b)(2). The Service takes the position that limitations on limited partners' ability to put their interest back to the partnership is a restriction under 2704(b) and should be ignored for valuation purposes. First of all, this is an invalid statutory interpretation. The Code's definition of an applicable restriction refers only to the corporation's or partnership's ability to liquidate. An application restriction, as defined in § 2704, has nothing to do with a shareholder's or partner's ability to sell their interest or have it redeemed by the entity. The fact that a partnership agreement may prohibit the putting of a partnership interest back to a partnership or the withdrawal of a partner has no bearing on the partnership's ability to liquidate. No other interpretation is possible based on the clear understanding of the statute. As stated earlier, the growing trend in many states is to change the applicable state partnership law to eliminate the right of any partner to put their interest back to the partnership. With respect to those states, which include Delaware, Georgia, California, Mississippi, New York, Missouri, Ohio, among others) § 2704(b) could never apply to restrictions on the ability of the partner to put their interest back to the partnership. Moreover, partnerships can be formed anywhere using the state law of another jurisdiction. Thus, arguably, given appropriate planning, 2704(b) would never apply even if the Service's interpretation of the section is upheld.

Even if a state's law does provide the right of a limited partner to put their interest and the Service's interpretation of 2704(b) is correct, ignoring the put provision with respect to the limited partnership interest should have no impact on the ultimate valuation of the limited partnership interest. That is because the transferee receives only the rights of an assignee and, under most state laws, an assignee has no right to sell their interest to the partnership. Thus, even if the partnership agreement was read so as not to limit the right of the limited partner to put their interest back to the partnership, the gift tax value of that partnership interest would still not vary significantly from that of an assignee interest regardless of whether § 2704(b) applied. This is further supported by the fact that even if the limited partner put their interest back to the partnership, they would only be entitled to receive "fair value" on their withdrawal. As discussed earlier, it would be unclear what fair value would be and what kind of consequential damages would occur due to a "unanticipated, premature" withdrawal by a limited partner from a partnership. Moreover, an assignee would never posses this right. Once more, it should also be noted that § 2704(b) does not contemplate the abolition of normal discounting principles. The conference committee report stated "these rules do not affect minority

discounts or other discounts available under present law." If § 2704(b) were to apply potentially to any entity that did not have a perpetual life (i.e., all entities other than corporations) due to limited partner put rights, then that would completely denude the legislative history of its clear meaning. Section 2704(b) cannot be read in context to mean that it precludes the availability of normal discounts to partnerships but not to corporations. It is our understanding that under most state laws, shareholders possess no put rights with respect to their shares. Clearly, § 2704(b) was not intended to be applied in a manner which only impacts the value of partnership interests and not corporate stock.

This leaves the Service with the less attractive arguments that the formation of a partnership itself was either a sham or a device under the principles of Schauerhamer and Murphy. As discussed previously, Estate of Bischoff, Estate of Harrison, and Estate of McClendon have all held that the family partnership structure does not violate the device test under the regulations under § 2031. Moreover, the Service has repeatedly ruled that the transfer of a limited partnership and retention of a general partnership interest does not violate IRS § 2036(a)(2) or § 2038 under the principles of United States v. Byrum, 408 US 125 (1972). Assuming the multiple purposes for the creation of the partnership can be adequately documented and supported, there should be no basis for asserting that the partnership is a device under § 2031. Obviously, the partnership would need to have more than a temporal existence and the terms of the partnership in its provisions would need to be respected. Otherwise, the taxpayer would run risks under either § § 2031 or 2036. However, in the typical partnership context, the partnership continues for a considerable period of time beyond its initial formation serving several valid purposes. In this normal fact pattern, the Service's arguments that the partnership is a device ring hollow.

VI. Charting a Course Through Troubled Waters

The Service's current attack on limited partnerships is merely a reflection of their unofficial denial of the existence of Rev. Rul. 93-12 or the principles espoused therein. However, their hope that Chapter 14 represented a legislative overturning of Rev. Rul. 93-12 is misplaced. Until the Service and Treasury are able to convince Congress to enact legislation contravening the principles of 93-12 and the underlying case law which is the foundation for Rev. Rul. 93-12, the Service should abandon its policy of belligerence towards taxpayer's who have made transfers of closely-held limited partnership interests, and their rulings should treat discounts of such interests for transfer tax purposes in a more even-handed manner.

In the meantime, taxpayers must make sure that the facts surrounding their use of the limited partnership structure do not warrant IRS challenge. The partnership must be entered into for valid business or investment purposes. Such purposes should be documented. Wherever possible, one partner should not be given the unilateral right to liquidate the partnership. Partnership agreements should be drafted using state laws where § 2704(b) is moot. Rights

and powers of assignees should be no greater than those provided under state law. Wherever possible, there should be more than one general partner. And, finally, the transfer of a partnership interest should give the recipient only the rights of an assignee under state law. If these principles are followed and the partnership interest is not transient in existence, then there should be no valid grounds for the Service to challenge the discounts found when valuing the partnership interest in either a gift or estate tax context.

---

go back

©1999 AICPA