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CURRENT VALUATION ISSUES INVOLVING FLPS, LLCS AND OTHER CLOSELY HELD ENTITIES

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I. OVERVIEW

The determination of the fair market value of an interest in property which is being transferred, either by gift or at death, is the foundation upon which our federal estate and gift tax system is built. The United States Supreme Court has often held that succession taxes, inheritance taxes and estate taxes are constitutional levies by the federal government only if they are applied in a manner that merely is an excise tax at the transfer of property at death. *See*, *e.g.*, *Knowlton v. Moore*, 178 U.S. 41 (1900); *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921). Therefore, only that property which is transferred as a result of a taxpayer's death or by gift during the taxpayer's life can be subjected to taxation under the federal estate and gift tax system. The tax cannot be a "wealth tax" or "property tax" on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax on the value of the asset transferred. *See* IRC §§ 2033, 2035-38, 2040(c), 2044 and 2501.

II. BASIC VALUATION PRINCIPLES

In determining the value of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, federal tax law takes over to determine how such rights and interests will be taxed. *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Comm'r*, 309 U.S. 78 (1940); *Estate of Nowell v. Comm'r*, 77 T.C.M. (CCH) 1239 (1999) (Cohen, C.J.). The valuation of property for transfer tax purposes is based upon the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b); Treas. Reg. § 25.2512-1. "The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is a not personalized one which envisions a particular buyer and seller." *LeFrak v. Comm'r*, 66 T.C.M. (CCH) 1297, 1299 (1993). "All relevant facts and elements of value as of the applicable valuation date shall be considered in every case." Treas. Reg. § 20.2031-1(b).

Because of this test, there are two primary components of federal estate and gift tax valuation: (1) understanding the state law rights being transferred from the hypothetical willing seller to the hypothetical willing buyer, and (2) determining the fair market value of the transferred rights.

III. FAMILY LIMITED PARTNERSHIP ISSUES - Dealing with the IRS's Arguments Regarding Family Limited Partnerships

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See*, *e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997);

PLR 9735003 (May 8, 1997); PLR 9730004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); and PLR 9723009 (February 24, 1997). Since those pronouncements were issued, a number of these arguments have been decided by the courts.

A. IRC § 2703 Argument

Sec. 2703. Certain Rights and Restrictions Disregarded

> (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* (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use *such property*.
>
> (b) EXCEPTIONS--Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

IRC § 2703 (emphasis added).

1. IRC § 2703 Cannot Be Used to Completely Ignore the Existence of a Partnership Validly Created and Existing Under State Law

In each of the National Office pronouncements, the Service took the position that IRC § 2703 allows the IRS to disregard the existence of a partnership under the theory that the partnership agreement is a "restriction on the right to sell or use" the property of the partnership which can be ignored under IRC § 2703 unless it meets the safe harbor provisions of IRC § 2703(b). The IRS has lost that argument in every case it pursued the argument. *See, e.g., Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd in part and rev'd in part on other grounds*, 293 F.3d 279 (5th Cir. 2002); *Church v. United States*, 85 A.F.T.R.2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion,* 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R.2d 2001-5352 (5th Cir. 2001).

2. IRC § 2703 Can Effect the Value of the Interest Transferred

In *Estate of Blount v. Comm'r,* T.C. Memo 2004-116 (May 12, 2004), the Tax Court addressed the question of whether the redemption price in a modified buy-sell agreement controlled the value of a decedent's closely-held stock for federal estate tax purposes. The decedent ("D") and his brother-in-law each owned 50% of the outstanding shares of stock in a construction company. In 1981, D, his brother-in-law, and the company entered into an agreement that restricted transfers of the company stock during both the shareholder's lifetimes and at death. The agreement required the company to buy a deceased stockholder's stock at an established price. Unless redetermined by the parties to the agreement, the purchase price would be equal to book value. In 1992, the company created an ESOP. The ESOP later became a third minority shareholder. After the redemption of the brother-in-law's shares following his death in January 1996, D's shares constituted a controlling 83.2% interest in the company.

In 1996 (without obtaining the ESOP's consent), D and the company modified the agreement, changing the price and terms under which the company would redeem D's shares at death, but leaving unchanged the provisions requiring the consent of other shareholders for lifetime transfers. The modified price was substantially below the price that would have been payable pursuant to the unmodified agreement. D died, and the company redeemed his shares pursuant to the modified agreement. D's estate reported the value of the shares held by D at death as equal to the price as set forth in the modified agreement.

The Court found that the restrictions in the modified buy-sell agreement were not binding on D during his lifetime because D, as the controlling shareholder, had the unilateral ability to amend the agreement. Therefore, under pre- § 2703 law, the agreement was disregarded for purposes of valuing the stock. In addition, the Court concluded that the agreement was subject to § 2703 because the modification significantly altered the rights of the parties with respect to the stock. The agreement did not fall within § 2703(b) because the estate failed to show that the modified agreement was comparable to similar arrangements entered into by persons in an arm's length transaction. The only evidence offered by the estate on the issue was testimony and the expert report of the estate's valuation expert, who testified that the terms of the modified agreement were comparable to similar arrangements entered into at arm's length <u>because</u> the price provided for in the agreement for D's shares was fair market value. The Court rejected this testimony, noting that the expert "did not present evidence of other buy-sell agreements or similar arrangements . . . actually entered into by persons at arm's length. Nor did he attempt to establish that the method decedent used to arrive at his $4 million price was similar to the method employed by unrelated parties acting at arm's length." Thus, the Court held that the modified agreement was disregarded under § 2703 in valuing D's stock.

In *Holman v. Comm'r*, 130 T.C. 12 (2008), the IRS argued that a right of first refusal contained in the partnership agreement should be ignored under § 2703. The right of first refusal permitted the Partnership (and if not exercised, the partners) to purchase an interest transferred to a "non-permitted transferee" at fair market value (*i.e.*, after

considering applicable lack of control and lack of marketability discounts). Applying the three part test of § 2703(b), the Tax Court determined that the right of first refusal and related transfer restrictions were not part of bona fide business arrangement. The Court noted that § 2703 contains no definition of the phrase "bona fide business arrangement." The Court stated that the provisions "do not serve bona fide business purposes because from its formation through the date of the 2001 gift, the Partnership carried on little activity other than holding shares of Dell stock." Despite undisputed testimony from the taxpayers that one of the primary purposes of the buy-sell provisions was to prevent transfers of interests outside of the family and to preserve the assets contributed to the Partnership, the Court held that § 2703(b)(1) had not been satisfied because the purposes of the Partnership (in the Court's view) did not include the operation of a closely held business.

The Court also found that the buy-sell provisions did not satisfy the "device" test of § 2703(b)(2). The Court found that the buy-sell provision would permit the Partnership to redeem the interests of an impermissible transferee for less than the proportionate share of the Partnership's net asset value, and the values of the remaining partners' interests in the Partnership would increase because of that redemption. Because the partners benefiting from any redemption would include one or more of the taxpayers' children, the Court found the transfer restrictions to be a device to transfer units in the Partnership to natural objects of the taxpayer's bounty for less than adequate consideration.

The 8th Circuit affirmed the decision of the Tax Court in a 2-to-1 decision. *Holman v. Comm'r*, 601 F.3d 763 (8th Cir. 2010). The majority applied a clear error standard of review and not a de novo standard. With respect to the § 2703 analysis, the majority determined that the buy/sell agreement did not satisfy the bona fide business arrangement test of § 2703(a) because the predominant purpose for the restrictions included in the partnership agreement was "estate planning, tax reduction, wealth transference, protection against dissipation by children, and education for the children." With respect to the willing buyer/willing seller test, the majority concluded that when the Tax Court calculated the discount for lack of marketability, it considered what a rational economic actor would deem appropriate and did not ascribe personal or non-economic motivations to a hypothetical purchaser.

The dissenting judge opined that the Holmans had satisfied the three required elements under § 2703(b). The dissent reasoned that the Holmans' goals of maintaining family control over the partnership, including the rights to participate as a partner and receive income, and protecting assets from outside creditors, were included as legitimate purposes in the legislative history of § 2703(b)(1). The dissent also noted that the Tax Court did not properly apply the willing buyer and the willing seller test in determining the lack of marketability discount for the partnership interests because it assumed that the hypothetical buyers already owned Holman limited partnership interests, in violation of the Tax Court's holding in *Estate of Jung v. Comm'r*, 101 T.C. 412, 438 (1993). The dissent noted that the "Tax Court's analysis is essentially based on the idea that a mere rational economic actor in the existing market would pay less than rational actors who already hold Holman limited partnership interests. Courts commit legal error where, as

here, they substitute hypothetical buyers for 'particular possible purchases' based on 'imaginary scenarios as to who a purchaser might be.'" *Id*. at 34, citing *Estate of Simplot v. Comm'r*, 249 F.3d 1191, 1195 (9th Cir. 2001).

B. The Indirect Gift/Gift on Formation Argument

The IRS's argument that a gift occurs when a partnership is created is based on the notion that if the value of the partnership interest received by a partner is less than the value of the assets contributed by the partner (under the fair market value definition of Treas. Reg. § 20.2031-1(b)), a gift has been made because someone must have received a gratuitous transfer of the difference. In support of this argument, the IRS commonly relies on *Comm'r v. Wemyss*, 324 U.S. 303 (1945), in which the Supreme Court stated that "[The gift tax statute by] taxing as gifts transfers that are not made for 'adequate and full [money] consideration' aims to reach those transfers which are withdrawn from the donor's estate." 324 U.S. at 307-308.

1. A Gift Does Not Occur Where the Creation of the Partnership Was a Bona Fide Arm's-Length Transaction That Was Free from Donative Intent

The "ordinary course of business" provision under Treas. Reg. § 25.2512-8 deems a transaction to be for "adequate and full consideration" under IRC § 2512(b), even if the purported transferor receives less consideration than a hypothetical willing seller would receive. A transfer is deemed to be for adequate and full consideration, and not subject to tax, if made "in the ordinary course of business (a transaction which is bona fide, at arm's-length, and free from donative intent)." Treas. Reg. § 25.2512-8. The creation of a mechanism to ensure family ownership and control of a family enterprise has long been held by the Tax Court to constitute a bona fide and valid business purpose. *See Estate of Bischoff v. Comm'r*, 69 T.C. 32, 39-41 (1977); *Estate of Reynolds v. Comm'r*, 55 T.C. 172, 194 (1970), *acq*., 1971-2 C.B. 1; *Estate of Littick v. Comm'r*, 31 T.C. 181, 187 (1958), *acq. in result*, 1984-2 C.B. 1; *Estate of Harrison*, 52 T.C.M. (CCH) at 1309.

2. A Partner Cannot Make a Gift to Herself

The IRS's claim that a gift on formation of the Partnership occurred also suffers from another fatal flaw -- a partner cannot not make a gift to herself. Assume that at formation, Mrs. Jones owned a 90% partnership interest in the partnership, and other family members own the rest. The partnership is pro rata and each family member received an interest in the partnership equal to the value of the assets contributed. The IRS would argue that because the value of Mrs. Jones' interest in the partnership was worth less than the assets she contributed, she has made a gift equal to the difference between the value of the assets received and the value of the assets transferred. If a gift was made by Mrs. Jones, she was the recipient of 90% of that gift. *See Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) (noting that the taxpayer could not make a gift to herself when she transferred her ranch to a newly formed corporation that she and her two sons owned all of the voting stock, the Court held that she had made a gift to each of her sons of one-third of the total gift amount); *Estate of Hitchon v. Comm'r*,

45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder sons).

On the other hand, in *Shepherd v. Comm'r*, a father and his two sons created a partnership and the father, at creation, transferred all of the assets to the partnership, and the sons made no individual capital contribution, the Tax Court held that the father had made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 376 (2000). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. In language which should give some level of comfort to creators of pro rata partnerships, the Tax Court stated that "obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of the contribution, thus entitling him to recoup the same amount upon liquidation of the partnership." *Id.* at 389. The Court also held, however, that the transfer should be treated as separate transfers of 25% to each son, and applied undivided interest discounts in determining the value of the gifts.

In *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), decedent formed a family limited partnership with his children and transferred assets to the partnership in return for a 99% limited partnership interest. The IRS argued that the decedent had made a gift when he transferred property to the partnership and received in return a limited partnership interest of lesser value. The Tax Court held that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of the contribution. Although the *Strangi* court rejected the IRS's gift on formation argument, it appeared to do so because the Tax Court did not believe that the decedent gave up control of his assets. As the Court stated, "in view of decedent's continuing interest in SFLP and the reflection of the contributions in his own capital account, he did not transfer more than a miniscule proportion of the value that would be 'lost' on the conveyance of his assets for the partnership in exchange for a partnership interest." *Estate of Strangi*, 115 T.C. at 490.

The Tax Court dealt the IRS's gift on formation a significant blow in *Estate of Jones v. Comm'r*, 116 T.C. 121 (2001). In that case, Mr. Jones formed a family limited partnership with his son and transferred assets including real property in exchange for a 95.5389% limited partnership interest. He also formed a family limited partnership with his four daughters and transferred real property to it in exchange for an 88.178% limited partnership interest. The son contributed real property in exchange for general and limited partnership interests in the first partnership, and the daughters contributed real property in exchange for general and limited partnership interests in the second partnership. All of the contributions were properly reflected in the capital accounts of the contributing partners. The IRS argued that Mr. Jones made taxable gifts upon contributing his property to the partnerships. "Using the value reported by decedent on his gift tax return, the IRS argues that, if decedent gave up property worth $17,615,857 and received back limited partnership interests worth only $6,675,156, decedent made

taxable gifts upon the formation of the partnerships equal to the difference in value." *Id*. at 127.

The Tax Court held that the contributions of property were similar to the contributions in *Strangi* and distinguishable from the gifts in *Shepherd*. "Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts." *Id.* at 128. Thus, even though Mr. Jones contributed most of the assets to the partnerships and received noncontrolling limited partnership interests in return, the Court held that he did not make a taxable gift on the formation of the partnerships because his contributions were properly reflected in his capital accounts when the entity was created and the value of the other partners' interests was not enhanced by his contributions.

In *Senda v. Comm'r*, T.C. Memo 2004-160 (July 12, 2004), husband and wife ("H and W") signed a partnership agreement on April 1, 1998, and the certificate of limited partnership was issued on June 3, 1998. On December 28, 1998, H and W contributed approximately $1.8 million worth of MCI WorldCom stock to a partnership, and their children purportedly transferred oral accounts receivable for their partnership interests (which were .10% limited partnership interests). The accounts receivable were never reduced to writing, had no terms for repayment, and had not been paid as of the time of trial. On that same day, H and W sent a facsimile to their accountant to inform him of the transfer of stock and (except for charges) to ask what percentage of the limited partnership interest they should transfer to their children. Later that day, H gave each child a 29.94657% LP interest, and W gave each child a .0434% LP interest. The court noted that "the certificates of ownership reflecting these transfers were not prepared and signed until several years thereafter."

A second partnership was created in 1999 in a similar manner. However, the facsimile to the accountant regarding what percentage interest in the second partnership should be given to the children was sent two days after the purported gifts of the partnership interests.

The IRS argued, and the Tax Court agreed, that the transfers of stock to the partnerships and the gifts of limited partnership interests to the children should be as gifts of the underlying stock (without discounts) rather than as gifts of discounted limited partnership interest. Relying on *Shepherd*, the Court concluded that there were no records or other reliable evidence that the parents contributed the stock to the partnerships before they made the gifts of partnership interests to the children. Although the parents argued that their capital accounts were increased by the amount of their contributions of stock to the partnership before the gifts were made, the Court found no evidence that the contributions were ever reflected in the parents' capital accounts.

The Eighth Circuit affirmed the Tax Court's decision, holding that the transfers of stock to the partnerships were indirect gifts of stock to the children because the taxpayers

did not present reliable evidence that they contributed the stock to the partnerships before they transferred the interests to the children. The Court held that the Tax Court did not clearly err when it reached its conclusion as the evidence demonstrated that (1) the husband, as general partner, did not maintain any books and records for the partnerships, and (2) there was considerable delay in preparing the tax returns and the certificates of ownership after the transfers. The Court further noted that letters from the tax advisors were inconclusive in proving that the taxpayers transferred the stock before transferring the partnership interests. *See Senda v. Comm'r*, 433 F.3d 1044 (8th Cir. 2006).

In *Holman v. Comm'r*, 130 T.C. 170 (2008), the Tax Court rejected the IRS's indirect gift theory with respect to gifts of limited partnership interests made shortly after the partnership was formed and funded. On November 2, 1999, the taxpayers and a trust created for the benefit of their children formed a limited partnership and transferred Dell stock to it. Each of the contributing partners received an interest in the Partnership equal to the number of Dell shares contributed. Six days after the Partnership was formed and funded, the taxpayers gave limited partnership interests to a custodianship account and to a trust for the benefit of their children. In 2000, 2001, and 2002, the taxpayers made additional gifts of limited partnership interests.

With respect to the November 8, 1999, transfers, the IRS argued that (1) the taxpayers had made an indirect gift of Dell stock and not of the partnership units, and (2) the formation, funding and gifts of partnership units were steps in an integrated donative transaction and that once the intermediate steps are collapsed, the taxpayers' gifts are of Dell stock "in the form of partnership units." The IRS did not make the same arguments with respect to the 2000 - 2002 gifts.

The Tax Court rejected the IRS's indirect gift argument, noting that the Partnership was formed and funded before any gifts of partnership interests were made. The Court noted that unlike the transactions in *Senda* and *Shepherd*, the taxpayer had satisfied its burden to show that they "did not first transfer LP units to [the trustee] and then transfer Dell shares to the Partnership, nor did they simultaneously transfer Dell shares to the Partnership and LP units to [the trustee]." *Holman*, 130 T.C. at 186.

The Court also rejected the IRS's argument that the formation and funding of the Partnership should be treated as occurring simultaneously with the 1999 gifts of limited partnership units because the events were interdependent and the separation and time between the first two steps (formation and funding) and the third (the gift) serve no purpose other than to avoid making an indirect gift under Treas. Reg. § 25.2511-1(h). The Court noted that the IRS did not ask it to consider either the 2000 gift (made approximately 2 months after the formation of the Partnership) or the 2001 gift (made approximately 15 months after the formation of the Partnership) to be indirect gifts of Dell shares. The Court further noted that the passage of time between the funding of the Partnership and the transfer of interests in the Partnership was "indicative of a change in circumstances that gives independent significance to a partner's transfer of property to a partnership and the subsequent gift of an interest in that partnership to another." The Court noted that "petitioners bore a real economic risk of a change in value of the Partnership for the six days that separated the transfer of Dell shares to the Partnership

account and the date of the 1999 gift." The Court thus held that the 1999 gift should be treated in the same way as the IRS conceded the 2000 and 2001 gifts should be treated -- as gifts of partnership units.

In *Gross v. Comm'r*, 96 T.C.M. (CCH) 187 (2008), the Tax Court again rejected the IRS's indirect gift theory regarding gifts of partnership interests made 11 days after the partnership was formed and funded. As in *Holman*, the Tax Court opined that the taxpayer did not make an indirect gift of the securities transferred to the partnership to her daughters. Rejecting the IRS's substance over form argument, the Tax Court noted that "all of the contributions were reflected in [the donor's] capital account, and the value of her daughters' capital accounts was not enhanced because of her contributions. After she contributed the [securities] to the partnership, she made gifts of interests in the partnership to her daughters." Rejecting the IRS's step transaction doctrine argument, the Tax Court noted that the donor bore a real economic risk of a change in value in the 11 days that had passed between the transfer of the securities to the partnership and the donor's gifts of interests in the partnership. The Tax Court noted, however, that "[w]e caution, however, in terms similar to those as we used in *Holman v. Comm'r*, 130 T.C. 170, 191, n.7 (2008): "The real economic risk of a change in value arises from the nature of the [securities] as heavily traded, relatively volatile common stock. We might view the impact of a 6-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term Government bond."

In *Linton v. United States*, 638 F. Supp.2d 1277 (W.D. Wash. 2009), the district court held in summary judgment proceedings that the taxpayers' transfer of property to an LLC on the same day that gifts of LLC interests were made to a trust for their children resulted in indirect gifts of the underlying assets.

Linton involved the initial creation of an LLC in late 2002. On January 22, 2003, (1) Mr. Linton gave 50 percent of his interest in the LLC to his wife, (2) Mr. Linton signed documents transferring assets, including undeveloped real property, cash and municipal bonds to the LLC, and (3) Mr. and Mrs. Linton created trusts for each of their four children. The trust agreements stated that the agreements were entered into effective upon contribution of property to the trusts and stating that "at the time of the signing of this Agreement, the Grantors have transferred percentage interests in" the LLC to the trustee. The same day, Mr. and Mrs. Linton also signed gift assignments collectively assigning 90 percent of the LLC interests to the trusts. The taxpayers' gift tax returns reported gifts of approximately $725,000 each (after discounts). The IRS asserted that no discounts should be allowed and that the gifts by each were approximately $1.5 million.

The court's analysis focused on Treas. Reg. § 25.2511-1(h)(1), which applies the indirect gift approach for contributions to a corporation. The court concluded that "the distinguishing factor for gift tax purposes is whether the donating partner's contribution of property was apportioned among the other partners or was attributed only to the donor's own capital account." If the contribution is apportioned directly among the other partners' capital accounts, the contribution is treated as an indirect gift to the other partners.

Analyzing the factual scenarios present in *Shepherd*, *Jones*, and *Senda*, the court held that "because the trusts were created, and gifts of LLC interests were made to the Trusts . . . either before or simultaneously with the contribution of property to" the LLC, "the case is analogous to both *Shepherd* and *Senda*, and that the Lintons transfer of real estate, cash and securities enhance the LLC interests held by the children's Trusts, thereby constituting indirect gifts to Trusts of pro rata shares of the assets conveyed to the LLC." The court also found that the step transaction doctrine applied to ignore the valuation discounts. Distinguishing *Holman* and *Gross* from the facts in *Linton*, the court noted that the donors did not delay the gifts for some period of time after funding of the LLC and there was no data concerning the fluctuations and the prices of the various securities on a daily basis during the period in question. Thus, the court held that the plaintiffs could not show "the volatility necessary to establish a real economic risk associated with" any delay that may have existed.

The Ninth Circuit reversed the district court's decision, holding that material issues of facts existed as to the sequence of the transactions in which the gifts were made. *Linton v. U.S.*, 630 F.3d 1211 (2011). The court noted that the attorney had erroneously dated the documents January 22, 2003, when the intent, according to the Lintons' accountant, was to date the documents January 31, 2003. Because the court could not determine at what point the couple had placed the gifts of the LLC interests "beyond retrieval" or otherwise objectively manifested an intent to make the gifts effective, it found there were material issues of fact as to when the gifts were complete under Washington law. In addition, the court found that the IRS was not entitled to summary judgment regarding the step transaction doctrine because the series of transactions made by the Lintons did not satisfy any of the three-step transaction tests.

Heckerman v. United States, 2009 WL 2240326 (W.D. Wash. 2009), is another gift tax case decided in the same federal district court (but by a different judge) as *Linton*. The court, granting the Government's motion for summary judgment, held that contributions of cash to an LLC and gifts of interests in the LLC on the same day should be treated as indirect gifts and as violative of the step transaction doctrine to eliminate valuation discounts for gift tax purposes.

On January 11, 2002, Mr. and Mrs. Heckerman transferred mutual funds (principally cash) to an LLC and on the same day transferred 49.60 percent interests in the LLC to trusts created for the benefit of their children. The documents assigning LLC interests and admitting the trusts as members of the LLC stated that the interests were signed "effective January 11, 2002." The gift tax returns attached an appraisal of the LLC interests based on a 58 percent discount. The IRS, however, asserted that the transfer of cash constituted an indirect gift to the trusts and, alternatively, that the step transaction doctrine applied to eliminate the valuation discounts.

Applying the same analysis as the court did in *Linton*, the court held that the facts were very similar to those of *Senda* and *Linton*, in that the transfer of assets to the LLC and gifts of interests in the LLC were made on the same day and the taxpayers could not prove which happened first. With respect to the step transaction doctrine, the court again distinguished *Holman* and *Gross* on the basis that there was no delay between the date of

funding and the date of the gifts and that the nature of the gifts (cash) was such that the taxpayers could not establish that there was any real economic risk that the LLC units would change value between the time of the funding and the gifts of LLC units. Finding that the "end result test" (which is based on whether a "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result") was satisfied because the donors "clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction.'" The court also held that the "interdependence test" of the step transaction doctrine had been satisfied because "it is clear from the record that but for the anticipated discount in calculating gift taxes, based on a low market appeal of Family LLC's structure, Plaintiffs would not have transferred the cash into Investments LLC."

C. Disregarded Entities/Step Transaction

In *Pierre v. Comm'r*, 133 T.C. 24 (2009), the Tax Court addressed the question of whether interests in a single member limited liability company (treated as a disregarded entity under § 7701) should be treated for gift tax purposes as transfers of proportionate shares of the underlying assets owned by the LLC or as transfers of interests in the LLC.

In *Pierre*, the LLC was organized on July 13, 2000. The taxpayer did not elect to treat the LLC as a corporation for federal tax purposes, and therefore the entity by default was treated as owned by the taxpayer "for federal tax purposes." On September 15, 2000, the taxpayer transferred $4.5 million in cash and marketable securities to the LLC. Twelve days later, the taxpayer transferred her entire interest in the LLC to two trusts, one created for the benefit of her son and the other created for the benefit of her daughter. The transfers consisted of a gift of a 9.5 percent interest and a sale of a 40.5 percent interest to each trust.

The IRS argued that because the taxpayer elected to treat the LLC as a disregarded entity for federal tax purposes under the § 7701 check-the-box regulations, the gift tax should be based upon the value of a proportionate share of the LLC's underlying assets. The taxpayer argued that state law, and not federal law, determined the nature of the interests transferred. Under applicable state law, a member has no interest in LLC property and the transfers of interests were properly valued as interests in the LLC (and subject to valuation discounts for lack of marketability and control).

The Majority decision of the Tax Court (authored by Judge Wells and joined by Judges Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison) analyzed the historical gift tax valuation regime and held that the check-the-box regulations do not explicitly alter "the long-established federal gift tax valuation regime." The Majority noted that Congress has enacted provisions of the Internal Revenue Code (*e.g.*, Chapter 14) that disregard valid state law restrictions in valuing transfers. In those cases, however, Congress expressly provided exceptions to address perceived valuation abuses. In the absence of explicit Congressional action and in light of the mandate in § 7701(a) that the check-the-box provisions apply only where the

application is not "manifestly incompatible with the intent" of the Internal Revenue Code, the Majority held that Congress did not intend to eliminate entity related discounts for single member LLC's in the gift tax context.

Judge Cohen, joined by eight other judges (including all of the judges that joined in the Majority opinion except Judge Morrison), authored a concurring opinion noting that the Majority opinion does not involve the issue of deference to the Commissioner's interpretation of a statute and its regulations because § 7701(a) precludes the application of the statute where its terms are "manifestly incompatible with the intent" of the Internal Revenue Code. The concurrence noted that "[w]e have never accorded deference to the Commissioner's litigating position, as contrasted to (1) contemporaneous expressions of intent when the regulations were adopted, and (2) consistent administrative interpretations before the litigation."

Judge Halpern dissented, arguing that the plain language of the § 7701(a) regulations requires a single entity LLC to be disregarded for *all* tax purposes, including federal gift tax purposes. Judge Halpern's dissent was joined by Judges Kroupa and Holmes. In addition, Judge Kroupa authored a separate dissenting opinion noting that the check-the-box regulations do not just apply for "federal *income* tax purposes." (emphasis in original). Judge Kroupa's dissent was joined by Judges Colvin, Halpern, Gale, Holmes and Paris.

On May 13, 2010, the Tax Court issued its second opinion in *Pierre v. Comm'r*, T.C. Memo 2010-106 (May 13, 2010). The Tax Court held that the step transaction doctrine applied to collapse the 9.5% gift and the 40.5% sale, which were made at approximately the same time, to each separate trust for valuation purposes. The Tax Court treated the transfers as an aggregate transfer of a 50% interest in the LLC to each trust. The Tax Court identified four reasons for concluding that the gift and sale were "integrated steps of a single transaction." The four reasons were (1) the transactions happened the same day; (2) no time elapsed other than "the time it took for documents to be signed"; (3) the taxpayer "intended to transfer her entire interest in [the LLC] without paying gift tax"; and (4) each trust's capital account in the LLC's journal and ledger were recorded with the notation "to reflect gift transfer by Suzanne Pierre to Jay Despretz Trust and K. Despretz Trust" rather than distinguishing the gift and sale transaction. The Tax Court thus found that "nothing of tax independent significance occurred in the moments between the gift transactions and the sale transactions" and that the transactions "were planned as a single transaction and that multiple steps were used solely for tax purposes."

The effect of the Tax Court's ruling on valuation, however, was not substantial. The taxpayer had argued for a 10% lack of control discount and a 30% lack of marketability discount. The Tax Court, relying on trial testimony from the taxpayer's expert, found that the lack of control discount should be reduced to 8%. Surprisingly, the Government submitted no expert testimony to support its valuation position.

D. Annual Exclusion Gifts

In *Price v. Comm'r*, T.C. Memo 2010-2 (Jan. 4, 2010), the Tax Court held that gifts of limited partnership interests did not constitute present interest gifts that qualify for the federal gift tax annual exclusion.

In the late 1990's, Mr. and Mrs. Price (the "Taxpayers"), as part of a financial plan to sell their company, Diesel Power Equipment Co. ("DPEC"), formed Price Investments Limited Partnership (the "Partnership") and transferred the stock of DPEC to the Partnership. Approximately a year later, the Partnership sold the DPEC stock and invested the sale proceeds in marketable securities. The 1% general partner was a corporation owned by the Taxpayers' revocable trusts, with Mr. Price as president. The 99% limited partnership was initially held equally by the Taxpayers' revocable trusts. During 1997 through 2002, the Taxpayers gave each of their three adult children interests in the partnership, intending for the gifts to qualify for the federal gift tax annual exclusion.

The partnership agreement provided that the partners could not sell partnership interests without written consent of all the partners and that the profits were to be distributed proportionally to all partners "in the discretion of the general partner except as otherwise directed by a majority in interest of all of the partners, both general and limited."

The IRS issued notices of deficiency for years 2001 and 2002, arguing that under *Hackl v. Comm'r*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003), the transferred partnership interests represent future interests because the partnership agreement effectively barred transfers to third parties and did not require income distributions to the limited partners. On the other hand, the Taxpayers claimed that the gifts were of a present interest because the donees could freely transfer their interests to one another or to the general partner. They further argued that each donee had immediate rights to partnership income and could freely assign income rights to third persons.

The Court applied the methodology in *Hackl* to determine whether the gifts were of a present interest. Under this test the annual exclusion is available if the donee has the right to immediate use, possession, or enjoyment of (1) the property transferred, or (2) the income from the property.

The Court first concluded that the donees did not have immediate substantial economic benefit from the property transferred because (1) of the transfer and sales restrictions imposed on the donees by the partnership agreement, (2) the donees were mere assignees and not substitute limited partners, and (3) pursuant to the partnership agreement the donees had no unilateral right to withdraw their capital accounts.

Finally, the Court determined that the donees did not have the right to immediate use, possession, or enjoyment of income from the property. The Court's analysis centered on the fact that pursuant to the partnership agreement, profits of the partnership were distributed at the discretion of the general partner. The Court noted that the

partnership's income did not flow steadily to the donees, as there were no distributions in 1997 or 2001 (despite substantial distributions in other years), and according to the partnership agreement the "annual or periodic distributions to the partners are secondary to the partnership's primary purpose of achieving a reasonable, compounded rate of return, on a long-term basis, with respect to its investments." Thus, the Court held that the Taxpayers were not entitled to annual exclusions for their gifts of partnership interests.

In *Estate of Wimmer v. Commissioner*, T.C. Memo 2012-157 (June 4, 2012), the Tax Court (Judge Paris) held that gifts of limited partnership interests over a five-year period qualified for the gift tax annual exclusion under § 2053(b).

From 1996 though 2000, George Wimmer made gifts of limited partnership interests in the George H. Wimmer Family Partnership, L.P., to "related parties" as defined in the partnership agreement. While the partnership agreement generally restricts transfers of partnership interests and limits the instances in which a transferee may become a substitute limited partner, the agreement creates an exception for transfers to related parties. Interests may be transferred to "related parties" without the prior consent of the general partners and those transferees are admitted as partners without prior written consent.

The assets of the partnership consisted of publicly traded and dividend paying stock. The partnership made distributions to the limited partners in 1996, 1997, and 1998 to pay federal income tax. Beginning in 1999, the partnership distributed all dividends, net of partnership expenses, to the partners in proportion to their partnership interests. Limited partners also had access to capital account withdrawal and in fact accessed those withdrawals.

The court analyzed whether the partnership interests constituted "present interests" in property that qualified for the annual exclusion under § 2053(b). The test is whether the transferee had the "unrestricted right to immediate use, possession, or enjoyment of property or the income from property." Treas. Reg. § 25.2503-3(b). The court noted "the terms, 'use, possess or enjoy' connote the right to substantial present economic benefit, that is, meaningful economic, as opposed to paper, rights." Citing *Hackl*, the court stated that because interests in a business entity were being transferred, "[t]he Court must probe, among other things 'whether the donees in fact received rights differing in any meaningful way from those that would have flowed from a traditional trust arrangement.'"

The court held that "the donees did not receive unrestricted and noncontingent rights to immediate use, possession, or enjoyment of the limited partnership interests themselves." The holding was based primarily on the fact that transfers to non-related parties were restricted unless certain requirements were met.

The court next considered whether the donees received certain rights in the income. The estate had to prove that "(1) the partnership would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of

income could be readily ascertained." The court held that because (1) the partnership continued to receive dividends from its assets during the relevant time period, (2)(a) the general partners were required to distribution a portion of partnership income each year to satisfy the partners' federal income tax liabilities and (b) distributions were required to be pro rata and some portion of partnership income was expected to flow to the partners each year, and (3) the partners could estimate their allocation of dividends on the basis of the stock's dividend history and their percentage ownership in the partnership, the estate met its burden. A key fact was that the partnership held publicly-traded, dividend-paying stock and the partnership made income tax distributions to the partners for the first three years at issue, and the partnership distributed all dividends (net of expenses) to the partners in the remaining years at issue.

The court thus found that "the limited partners received a substantial present economic benefit sufficient to render the gifts of limited partnership interests present interest gifts on the date of each gift. Accordingly, the gifts qualify for the annual gift tax exclusion under section 2503(b)."

E. IRC § 2036(a)

The primary area in which the IRS has experienced success in connection with its challenges to family limited partnerships involved situations where the taxpayers failed to respect the integrity of the entity. In these cases, the Tax Court has used IRC § 2036(a) to bring the value of the assets of the partnership back into the decedent's estate as a retained life interest. Section 2036(a) provides as follows:

> (a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> > (1) the possession or enjoyment of, or the right to the income from, the property, or
> >
> > (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

F. Significant § 2036 Cases

1. *Estate of Cohen v. Comm'r*

The § 2036(a)(2) position taken by the Tax Court in *Strangi* is contrary to the position taken by the Tax Court in *Estate of Cohen v. Comm'r*, 79 T.C. 1015 (1982). In *Cohen*, the decedent was a co-trustee of a Massachusetts business trust. The trust agreement gave the decedent and his co-trustees broad management powers with respect to the property of the trust, including the discretionary power to determine whether to declare dividends on common shares of the business trust. The IRS argued that the dividend power possessed by the decedent and his co-trustees gave them the "right" to designate the persons who enjoy trust income. *Id.* at 1023.

The Court began its discussion by analyzing *Byrum*, noting that the *Byrum* court:

> [R]ejected the contention that this de facto power to affect dividend policy was "tantamount to the right to designate the persons who shall enjoy trust income" (408 U.S. at 144), emphasizing the fiduciary obligations imposed upon both majority shareholders and corporate directors under the applicable local law. In view of these fiduciary constraints, Byrum's theoretical power in respect of dividends was not an "ascertainable and legally enforceable" right (408 U.S. at 136-37), and thus was not a "right" within the meaning of section 2036(a)(2).

Id. at 1023-24.

The *Cohen* Court emphasized the similarities between the Massachusetts business trust and the corporation in *Byrum*, and stated that "the very fact that we are concerned here with the declaration of ***dividends*** on ***shares*** representing interests in the entity bolsters the corporate analogy, and thus the relevance of *Byrum*." *Id.* at 1025 (emphasis in original). The Court further opined that:

> In *Byrum*, the critical impediments to the transformation of the power to affect dividend policy into a right to designate enjoyment were the fiduciary obligations imposed by local law on *Byrum* as a controlling shareholder and on the corporate directors he could elect. Therefore, the issue here must turn upon the construction of this trust agreement under Massachusetts law. ***If the agreement may be said to give the trustees unlimited discretion in this respect, so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a "right" under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such "right" exists.***

Id. (emphasis added).

The Court determined that a fair reading of the trust agreement would permit the omission of the dividend (or a reduction in amount) "only if the determination to eliminate or reduce the dividend were made in good faith and in the exercise of a bona fide business judgment." *Id.* at 1026. The Court further found that while "it was within the discretion of the trustees to prefer a business opportunity over a larger dividend, . . . there is no implication that the trustees could simply forego dividends without justification." *Id.* at 1026. Thus, the Court held that:

> In view of the perceived limitations on the dividend power in the trust agreement in question, and the apparent willingness of the Massachusetts courts to hold business trustees to a fair standard of conduct, we conclude that the decedent and his sons did not have the power to withhold dividends arbitrarily. Thus, they did not have an "ascertainable and legally enforceable" *right* to shift income between the classes of shareholders, and the dividend power does not require inclusion of either the common or preferred shares in the decedent's estate under section 2036(a)(2). We think *Byrum* is controlling.

Id. at 1027.

2. ***Estate of Murphy v. United States***

In *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009), the Federal District Court for the Western District of Arkansas addressed a refund claim involving the IRS's attempt to apply § 2036 to the assets contributed by the decedent to a family limited partnership.

Charles H. Murphy, Jr. had been involved for over 50 years in the oil and gas, banking, and timber businesses. He created Murphy Oil Company, which spun off Deltic Land & Timber Co. He also owned substantial interests in two banking enterprises and other assets.

In 1997, after several years of planning, he formed a partnership to centralize management of core family assets and protect against dissipation of those assets. He transferred his interests in Murphy Oil Company, Deltic Land & Timber Co., and First United Bancshares, Inc. (which later became Bancorp South) to the partnership and the limited liability company that was the general partner. Two of his four children also contributed stock of these companies to the limited liability company. Mr. Murphy contributed assets worth approximately $90 million; he retained assets worth approximately $130 million outside of the partnership. Mr. Murphy acquired a 96.75 percent limited partnership interest and a 49 percent interest in the LLC general partner. His two children each acquired a 25.5 percent interest in the LLC. He gave away a one percent limited partnership interest to a university as a charitable gift.

The creation of the partnership was a part of Mr. Murphy's process of turning over management of family assets to the next generation. Two of his children shared his business/investment philosophy and were actively involved with the management of the partnership, its employees and its assets. Mr. Murphy's youngest son continued serving on the board of directors of the three corporations comprising the family's core assets. The partnership purchased 16,000 acres of farmland and timberland and made significant capital improvements to them. This property was purchased from Deltic Timber, and had comprised some of the Murphy family's early landholdings.

The partnership made only two distributions during Mr. Murphy's life. The first was a pro rata distribution in the first year to cover the partners' federal income taxes attributable to partnership income. The second distribution was a distribution of stock in a small company that was necessary to allow the company to convert to an S Corporation. This second distribution reduced Mr. Murphy's percentage interest in the partnership and his capital account.

Mr. Murphy made annual exclusion gifts of partnership interests to his children, their spouses and his grandchildren. At the time of his death, he owned a 95.25365 percent limited partnership interest and a 49 percent interest in the LLC. The assets of the partnership grew to $131.5 million at the time of his death. Mr. Murphy's estate reported the value of his 95.25 percent limited partnership interest at $74 million, based upon a combined 41 percent discount for lack of control and lack of marketability.

Between the time Mr. Murphy funded the partnership and his death, assets held by Mr. Murphy outside of the partnership had declined substantially in value. The estate needed additional liquidity to pay estate taxes. The estate borrowed $11 million from the partnership under a nine-year "Graegin" note which was secured by a 14.36 percent limited partnership interest.

After an audit, the IRS issued a notice of deficiency seeking additional taxes of $34 million plus interest. The IRS alleged that the estate undervalued various assets, and subsequently alleged that the partnership assets were includable in Mr. Murphy's estate under § 2036. The IRS also denied the deduction for the interest on the loan used to pay estate taxes. In response to the notice of deficiency, the estate borrowed approximately $41 million from family trusts to pay the additional tax and interest, and filed a claim for refund. When the claim for refund was denied, the estate filed suit in the federal district court.

In its Findings of Fact and Conclusions of Law issued October 2, 2009, the court held that § 2036 did not apply to the partnership because the creation of the partnership qualified for the bona fide sale for adequate and full consideration exception under § 2036. The court found that the purpose of the partnership included pooling the family's legacy assets into one entity to be centrally managed in a manner that was consistent with Mr. Murphy's long-term business/investment philosophy. The court noted that Mr. Murphy's youngest son was actively involved in the management of the partnership's assets, and the partnership purchased and managed property consistent with the goal of acquiring and maintaining the family's historical assets. The court also noted

that Mr. Murphy retained $130 million of assets outside of the partnership, he did not treat the partnership assets as his own and did not commingle assets of his own with the partnership's assets. Finally, the court noted that the children who were involved with the partnership took an active role in its formation, and Mr. Murphy's daughter was represented by her own attorney.

3. *Estate of Black v. Comm'r*

In *Estate of Black v. Comm'r*, 133 T.C. 15 (2009), the Tax Court held that the value of property contributed to a family limited partnership by Samuel P. Black, Jr. ("Mr. Black") was not includable in his gross estate under IRC § 2036 because the "bona fide sale for adequate consideration" exception was met.

Mr. Black and members of his family were the second largest shareholders of stock in Erie Indemnity Company. Mr. Black had previously made gifts of his Erie stock to his son and to two trusts set up for the benefit of his grandsons. In 1993, Mr. Black, his son, and the two trusts contributed their Erie stock to Black Limited Partnership ("Black LP"), a family limited partnership, in exchange for partnership interests in proportion to the fair market value of their respective contributions. The principal reasons for creating Black LP included: (i) perpetuating Mr. Black's buy-and-hold investment philosophy with respect to the Erie stock; (ii) placing the family's Erie stock under greater investment controls; (iii) allowing the Black family to maintain a seat on the board of directors and giving the family potential "swing vote" powers; and (iv) protection against future creditors and failed marriages. Of the Erie stock contributed to the partnership, Mr. Black contributed almost $69 million, his son contributed over $11 million, and the trusts for his grandchildren contributed almost $1 million.

Mr. Black died in December of 2001 and his wife died five months later. The IRS argued that § 2036 applied to the transfer of Erie stock by Mr. Black to Black LP, causing a pro rata portion of the underlying assets to be included in Mr. Black's gross estate.

In analyzing the IRS's argument, the Tax Court focused on the "bona fide sale for adequate consideration" exception to § 2036. As in *Schutt*, the Court examined the exception under the "legitimate and significant non-tax reason" standard. Also, the Court used the Third Circuit's requirement in *Thompson* and *Turner* for the need for some potential benefit to the transferor other than estate tax benefits. The Court found that the reasons for the creation of the partnership were substantially similar to those of *Schutt*, and that the partnership was formed for legitimate and significant nontax purposes.

Next, the Court examined the "adequate consideration" leg of the exception, under the four factor test used in *Schutt*:

> (1) The participants in the entity at the issue received interests proportionate to the value of the property each contributed to the entity; (2) the respective contributed assets were properly credited to transferors' capital accounts; (3) distributions required negative adjustments to

> distributee capital accounts; and (4) there was a legitimate and significant nontax reason for the formation of the entity.

Id. The factors were met in this case, but the Court went further and addressed the concerns expressed by the Third Circuit in *Thompson* that the value of the interests received in the partnership is often less than the value of the assets contributed, especially when the partnership does not operate a "legitimate business." The Court reasoned that the operation of a legitimate business is not required as long as the partnership has a legitimate and significant nontax purpose and obtaining a valuation discount is not the sole benefit of the partnership. Because this was found this to be true under the "bona fide" leg of the statutory test, the Court held that the transfer was made for adequate and full consideration. Therefore, the fair market value of Mr. Black's interest in Black LP, rather than the value of the underlying assets, was includable in his gross estate.

4. *Estate of Turner v. Comm'r*

In *Estate of Turner v. Comm'r*, T.C. Memo 2011-209 (Aug. 30, 2011), the Tax Court held that the value of property contributed to a family limited partnership by Clyde W. Turner, Sr. ("Mr. Turner") was includable in his estate under both §§ 2036(a)(1) and (a)(2).

Before his death, Mr. Turner had operated a lumber company with his brothers and used income generated by the company to acquire additional assets, principally stock of Regions Bank. Mr. Turner's father was the first depositor of Regions Bank and several family members had served on his board of directors. Mr. Turner also inherited some Regions Bank stock from his father, and he sold few, if any, shares over the years. By the time of his death, the stock had appreciated greatly in value, had paid dividends for years, and was the cornerstone of his wealth. Mr. Turner had other investments, including real estate. While he did not follow any particular investment strategy, he strongly believed in Regions Bank stock as a long-term investment.

In 2001, Mr. Turner recognized that his family investments were "really in a scrambled situation" and asked one of his grandsons to make a recommendation regarding asset management. In 2002, the family retained an estate planner who created the "Turner & Co. Limited Liability Partnership" (the "Partnership"). The Partnership was formed on April 15, 2002. It was funded with cash, Regions Bank stock, other stocks, CDs and various investment accounts. Sixty percent of the assets consisted of Regions Bank stock. At the time he formed the Partnership, Mr. Turner was in good health. He retained $2 million of assets outside of the Partnership.

During 2002 and 2003, Mr. Turner and his wife gave limited partnership interests to their three children and grandchildren. Mr. Turner died on February 4, 2004, after a brief illness. At his death, Mr. Turner owned a .5% general partner interest (the only general partner interest) and a 27.8% limited partner interest. The Internal Revenue Service argued that § 2036 applied to all of the assets transferred to the Partnership by Mr. Turner.

The Court first focused on whether Mr. Turner's transfer of assets to the Partnership satisfied the bona fide sale for full and adequate consideration exception. Noting that the partnership agreement was modeled on a standard form, the Court stated that some of the purposes listed in the partnership agreement did not apply to the Turner family. The Estate argued that Mr. Turner had several nontax reasons for creating the Partnership not listed in the partnership agreement. Those reasons were (1) consolidation of assets for management purposes; (2) facilitation of resolution of family disputes; (3) protecting family assets from one of the grandchildren and protecting that child from himself.

The Court rejected each of the proffered nontax reasons. First, the Court noted that although consolidation of assets can be a legitimate nontax purpose, the assets transferred to the Partnership were passive investments that did not require active management. The Court further noted that Mr. Turner did not have a distinct investment philosophy that he hoped to perpetuate and his daughter already had significant management responsibility with respect to the assets. Second, the Court rejected the Partnership as a tool to resolve family disputes, stating that the ill will among Mr. Turner's children was not about money and could not be solved by the Partnership. Third, the Court noted that although asset protection could be a legitimate nontax purpose, it did not apply in this case. Although one of the grandchildren had significant drug problems, previous transfers to that grandchild had been voluntarily made and nothing in the record indicated that the grandchild was a threat to the assets. The Court further observed that since Mr. Turner held $2 million outside of the Partnership, exposure to the grandchild continued despite the creation of the Partnership.

The Court identified several additional factors that led the Court to conclude that the transfers to the Partnership were not "bona fide." First, the Court stated that Mr. Turner was on "both sides of the transaction" and created the Partnership without any meaningful bargaining or negotiating with his wife (an original partner) or with any of the other anticipated limited partners. Second, Mr. Turner apparently commingled personal and partnership funds when he used partnership funds to make personal gifts, to pay premiums on life insurance policies for the benefit of his children and grandchildren, and to pay legal fees relating to estate planning. Third, the Court noted that Mr. Turner did not complete the transfer of assets to the Partnership for at least eight months after the Partnership was formed.

The Court also found that Mr. Turner retained possession and enjoyment of the assets transferred to the Partnership under § 2036(a)(1). The findings of the Court included the following: (1) Mr. Turner received excessive management fees of $2,000 per month given the Court's observation that he did not manage partnership assets at all; (2) Mr. Turner transferred most of his assets to the Partnership; (3) Mr. Turner used partnership funds to make personal gifts, to pay life insurance premiums, and pay legal fees associated with his estate planning; and (4) Mr. Turner commingled personal and partnership funds when he personally paid a partnership debt, purchased property on behalf of the Partnership, and reimbursed the Partnership for its purchase of certain notes without documentation.

The Court also found that § 2036(a)(2) applied because Mr. Turner, as general partner, had the sole and absolute discretion to make pro rata distributions of partnership income and to make distributions in kind. In addition, Mr. Turner had the authority to amend the partnership agreement at any time without consent of other limited partners.

In *Turner II* (*Estate of Turner v. Comm'r*, 138 T.C. 306 (March 29, 2012)), the court addressed the estate's motion for reconsideration regarding (1) the § 2036 issue, and (2) whether the marital deduction operated to exclude from the taxable estate the value of the partnership assets attributable to the assets included in the estate under § 2036. The court affirmed its § 2036 holding. As to the second point, the estate argued that there should be no estate tax deficiency because the formula marital deduction clause in Mr. Turner's will allowed the estate to claim an increase in the estate tax marital deduction.

As to the marital deduction issue, the court acknowledged that applying § 2036 in the context of a family limited partnership raises two potential marital deduction issues on the death of the first spouse. First, potential mismatch between the date of death value of the ***partnership assets*** included in the gross estate under § 2036 and the fair market value of ***partnership interests*** used to fund the marital bequest.[1] The court concluded that this mismatch problem did not exist because the IRS increased the marital deduction by calculating it on the basis of the value of the assets transferred in exchange for the partnership interests that were owned by the decedent at death and used to fund the marital deduction bequest.

The second marital deduction mismatch issue that can arise is when lifetime gifts are made of partnership interests to someone other than a spouse, and the date of death value of the assets attributable to those partnership interests is included in the transferor's gross estate under § 2036. The estate asserted that the formula marital deduction should be recalculated based on the date of death value of the assets attributable to the partnership interests given away during Mr. Turner's life. The estate posited that § 2036 creates a legal fiction for purposes of the gross estate, and for consistency purposes, the marital deduction should be increased to reflect that legal fiction. The estate also argued that it would be inconsistent to conclude that the decedent retained a right to possess or enjoy the assets contributed to the family limited partnership, while at the same time ignoring the value of those assets included in the gross estate under § 2036 in calculating the marital deduction.

The court rejected the estate's arguments, stating that the estate tax marital deduction is based on a property interest that passes to or for the benefit of a surviving spouse, not the limited partnership interests that were given to family members (other than the surviving spouse) nor the underlying assets passed to or for the benefit of the surviving spouse. The court thus held that the estate could not deduct the value of either the gifted partnership interests or the underlying assets.

[1] This issue was raised by the IRS in *Estate of Black* and *Estate of Shurtz*. However, since § 2036 did not apply in those cases, the court did not reach the issue.

The court noted that the policy behind the marital deduction is one of deferral of tax rather than elimination of tax. Marital deduction property that is owned by the surviving spouse at death is subject to estate tax. In regard to the assets attributable to the partnership interest that Mr. Turner gave to other family members, his surviving spouse did not have beneficial ownership. The court opined that allowing a marital deduction for the value of the gifted partnership interests or the value of the underlying assets would result in assets leaving the marital unit without tax at the first spouse's death or upon a transfer by gift or at the death of the surviving spouse.

5. *Estate of Kelly v. Comm'r*

In *Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012), the Tax Court (Judge Foley) held that § 2036 does not require estate tax inclusion of operating quarries and other real property and assets contributed to a partnership during a guardianship proceeding. *Kelly* involved the creation of a partnership under a court order allowing the decedent's guardianship estate to contribute operating quarries and other assets to limited partnerships. The general partner of the partnerships was a corporation owned entirely by the decedent. The primary reasons proffered for the creation of the entities were to (1) ensure the equal distribution of the decedent's estate, thereby avoiding litigation after the decedent's death, (2) provide effective management, and (3) address potential liability concerns. The plan provided for the management of the assets (many of which required active management). Ms. Kelly retained $1.1 million out of the partnerships, and no distributions from the partnerships were used to pay any of her living expenses. The court found that the reasons for creating the partnership were legitimate and significant non-tax reasons, and the bona fide sale for full and adequate consideration exception applied.

Ms. Kelly also made gifts of limited partnership interests prior to her death. The IRS argued that the parties had an implied agreement that the decedent would continue to enjoy the income from the partnerships and that the partnerships' assets attributable to those gifted interests were includable in the gross estate under § 2036(a)(1). The IRS also argued that the language in the petition to the guardianship court for authority to implement the plan, which provided that the decedent would own all of the outstanding stock of the corporate general partner and that the management fee received would ensure that the ward would be provided with adequate income to cover her probable expenses for support, care and maintenance for her lifetime, was evidence of a retained right. The court rejected this argument, noting that the parties respected the entities, the decedent retained sufficient assets for living expenses, the management fee paid to the corporation was not used to pay living expenses, the fiduciary duties limited the fee to reasonable management fees, and the management fee paid to the company were in fact reasonable.

* * * * *

Factors examined by the courts in deciding whether § 2036 applies are case specific and continue to be developed through litigation and in the appeals of decisions such as *Strangi* and *Thompson.* "Formation" facts looked at by the courts have included: (1) the non-tax reasons for creating the entity; (2) whether the other partners made real

contributions of property or services; (3) whether the decedent had sufficient assets outside of the partnership to live on; (4) whether personal use assets were placed in the partnership; (5) whether fiduciary obligations were negated in the partnership agreement; (6) whether partners other than the decedent had the opportunity to comment on and provide input with respect to the terms of the partnership agreement; (7) whether partners other than the decedent had the opportunity to decide what assets would be contributed to the partnership; and (8) the discretion regarding distributions provided to the decedent general partner. "Operational" facts looked at by the courts include (1) whether the non-tax reasons for creating the entity are consistent with how it was operated; (2) whether partnership assets were commingled with the decedent's personal assets; (3) whether distributions were made in accordance with the terms of the partnership agreement; (4) whether the entity was treated and respected as a separate entity; (5) whether personal expenses of the decedent were paid from the partnership or whether distributions were made for personal needs; and (6) whether estate taxes and administration expenses were paid directly from the partnership.

IV. APPEALS COORDINATED ISSUES SETTLEMENT GUIDELINES

On October 20, 2006, the National Office of the Internal Revenue Service issued Appeals Coordinated Issues Settlement Guidelines (the "Guidelines"). The Guidelines indicate that IRS Appeals is focusing on four basic issues: (1) validity of the partnership or LLC under §§ 2036 and 2038; (2) valuation; (3) indirect gifts; and (4) penalties.

With respect to valuation, the Guidelines note, "as a general rule, the allowable discounts are related to the risks of the underlying investments held by the entity. Greater risks warrant greater discounts." The Guidelines focus on three Tax Court decisions, *McCord*, *Peracchio*, and *Lappo*, and the discounts determined to be appropriate in these cases. The Guidelines also note that while the restricted stock studies support a lack of marketability discount, they should be carefully considered. While the Guidelines state that more recent restricted stock studies have shown a lesser lack of marketability discount, they fail to note that much of the reduction in the discounts seen in the restricted stock studies is attributable to the reduction of the Rule 144 holding period from two years to one year. The Guidelines also criticize as an anomaly the 32 percent combined lack of control and lack of marketability discount found by the Tax Court in *Kelley*. The IRS criticizes the discount as too high in light of the low risk in the underlying partnership assets (cash and cash equivalents). The Guidelines essentially take the position that no minority interest discount is appropriate for cash or cash equivalents.

With respect to §§ 2036 and 2038, the Guidelines review various cases, including some won by the Government and some lost by the Government. Negative factors highlighted include (1) commingling of partnership and personal funds; (2) a personal use of property being used by the senior family member without the payment of fair rental; (3) disproportionate distributions; and (4) failure to transfer assets to the partnership that were intended to be contributed. The Guidelines also focus on the language in the *Estate of Thompson* as authority for the proposition that partnership distributions for the purpose of enabling a partner to maintain his or her lifestyle, including the making of annual

exclusion gifts, is a basis for § 2036 inclusion. Contribution of substantially all of a decedent's assets to a partnership was also cited as a red flag under § 2036.

With respect to indirect gifts (*i.e.*, *Senda* and *Shepherd*), the Guidelines indicate that the IRS will in certain cases use a step transaction approach to attack discounts involving gifted partnership interests if either (i) the funding occurs after the interests are transferred, or (ii) there is sufficient evidence of prearranged gifts at the time of funding.

With respect to penalties, the IRS warns that appraisals claiming "an egregious discount" may not be reasonably relied upon for penalty defense purposes. The Guidelines state that penalty issues should be considered on their own merit and should not be traded for other concessions.

V. FORMULA TRANSFERS

In planning involving the transfer of hard-to-value assets such as interests in closely held entities, job one is to engage a qualified and experienced appraiser to determine the value of the asset transferred. Some clients, however, do not desire to run the risk of the IRS attempting to take a contrary valuation position in an attempt to impose additional gift or estate tax. For this reason, formula clauses have been used by careful practitioners for years to remove valuation uncertainty from transactions.

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax. Formula clauses are designed to limit the transferor's gift exposure by either adjusting the value of the interest transferred to the extent a different value is "finally determined for gift tax purposes" (a "value adjustment clause") or specifying the dollar value of the interest transferred (a "defined value clause").

Because a formula clause may negate an IRS attempt to impose additional transfer tax, the IRS has challenged their use under a variety of theories. The IRS asserts that formula adjustment clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS's and the court's time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the clause kicks in to adjust the transaction so that no gift tax is owed. Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS.

Given the numerous types of formula clauses routinely sanctioned by the Treasury, the IRS's position seems disingenuous. These clauses include:

- Formula marital deduction clauses (Rev. Proc. 64-19, 1964-1 C.B. 682)
- Formula GST transfers (Treas. Regs. §§ 26.2632-1(b)(2)(11), 26.2632-1(d)(1))

- Split-interest charitable trusts (Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(e)(2)(vi)(a))
- Formula transfers to a GRAT (Treas. Reg. § 25.2702-3(b)(1)(ii)(B))

In each example, the formulaic adjustment would be made ***only*** if the value of the transferred property is determined to be different than the originally reported value.

Over the years, several value adjustment clauses have been tested in the courts, with the results historically favoring the IRS's position that the transfer tax consequences of the transfer should be determined without regard to the clause. But recent decisions in *McCord, Hendrix*, *Christiansen*, *Petter*, and *Wandry* provide the taxpayer with substantial reason to be optimistic about the use of formula clauses and provide needed guidance to practitioners in their use and implementation.

A. Value Adjustment Clauses

There are generally two types of value adjustment clauses. The first type of clause provides that if it is finally determined for transfer tax purposes that the value of the property transferred exceeds a specified dollar amount (*e.g*., by agreement with the IRS or by a court decision), the size of the transferred interest is reduced so that the value of the property transferred equals the specified dollar amount. The second type of clause, rather than adjusting the size of the transferred interest, requires the transferee to give additional consideration to the transferor equal to the difference between the value of the interest as finally determined for transfer tax purposes and the specified dollar amount.

The validity of value adjustment clauses was first addressed in *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the taxpayer transferred property and provided in the transfer document that if it were determined by a final judgment of a court of last resort that any part of the transfer was subject to gift tax, the property subject to gift tax would be deemed excluded from the transfer and would remain the transferor's property. The Fourth Circuit Court of Appeals held that the provision did not eliminate the taxable gift because it imposed a condition subsequent that violated public policy. The court determined that the provision would be "trifling with the judicial process" (*id.* at 827) and would inhibit tax collection since attempts to enforce the tax would defeat the gift. Moreover, the court held that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot once the decision was rendered.

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for Federal gift tax purposes . . ." to exceed $2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred

property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

The only pre-*McCord* decision upholding the validity of a formula transfer was the Tenth Circuit's decision in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), which involved the sale of stock pursuant to a value (or purchase price) adjustment clause. In *King*, the taxpayer sold stock to trusts for his children for $1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales agreements provided that "if the fair market value . . . as of the date of . . . [the agreement] is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." 545 F.2d at 703-04. The IRS took the position that the shares were worth more than $1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

> Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction.

Id. at 705. The Tenth Circuit found that the *King* clause had a proper purpose; that is, "an attempt to avoid valuation disputes with the Internal Revenue Service agents by removing incentive to pursue such questions is not contrary to public policy in the absence of a showing of abuse."

B. Value Definition Clauses

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a $1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of

$1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011 (issued in connection with the *McCord* audit), the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter*, *Ward*, and their progeny.

C. Recent Decisions Favor the Use of Formula Clauses

1. *McCord* – Value in Excess of a Defined Amount Goes to Charity (2006)

The application of *Procter* and *Ward* to value definition clauses was directly at issue in *McCord v. Comm'r*, 120 T.C. 358 (2003). In *McCord*, the taxpayers made a gift of their 82% limited partnership interests to a group consisting of their sons, generation-skipping trusts for the benefit of each son's family line, and two charities. The gift was made using a value definition clause in which the taxpayers specified that their sons and the trusts, collectively, had the right to receive that portion of the transferred interests having a fair market value of $6.9 million with the remainder of the interests passing to the charities. The taxpayers left it up to the donees to determine what portion of the 82% interest passed to the sons and the trusts (*i.e.*, what portion of the interest had a fair market value of $6.9 million), and what portion passed to the charities. After the gift was made and after an appraisal was obtained, the donees entered into an arm's length agreement as to the percentage interest each received in a document entitled "Confirmation Agreement." The partnership redeemed the charities' interests approximately seven months after the gifts.

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51 (1958)), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of $6.9 million. Thus, the value of the gift to the sons and the trusts was equal to $6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS. Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See*, *e.g*., Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. § 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the Treasury Regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Regs. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount

passing to charity under a charitable trust. Treas. Reg. §§ 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes), 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made). *See also* Rev. Rul. 72-392, 1972-2 C.B. 573, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

The taxpayer also distinguished *Procter* and its progeny because the cases involved formula clauses that attempted to adjust the terms of a gift *after the gift was made*. In those cases, assets were purported to be transferred in such a way that, if it was determined by the IRS or the court that a portion of the transfer would be subject to gift tax, the transaction was adjusted after-the-fact such that those portions were no longer subject to gift tax. *See, e.g., Procter*, 142 F.2d at 827; *Ward*, 87 T.C. at 114. Contrasting the case with *Procter*, the value of the interests transferred under the *McCord* defined value clause to the sons and the trusts were readily determinable, and were not subject to change. The sons and the trusts were entitled, collectively, to the first $6.9 million of transferred interests. The value of the transfer to the sons and the trusts was unaffected by any determination by the court or by the IRS. The taxpayers were simply trying to determine and establish with certainty, through the use of a formula clause specifying the dollar value of the interest in the partnership passing to each donee, the amount of gift tax that would result from the transfers. The taxpayers argued that the property rights transferred by the taxpayers to the sons and the trusts -- the right to receive assignee interests in the partnership with a fair market value of $6.9 million -- were clearly set forth in the assignment agreement and should be given effect for purposes of calculating the taxpayers' gift tax. *See Morgan v. Comm'r*, 309 U.S. 78, 80-81 (1940).

A majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred. *McCord v. Comm'r*, 120 T.C. 358 (2003). The Tax Court opined that the formula clause was not self-effectuating, and it was thus necessary to look to the confirmation agreement to determine the percentage interest that each donee received.

The majority thus concluded that the donor was entitled to a charitable deduction equal to $594,743. This amount was higher than the dollar figure the charities received when their interests were redeemed six months after the assignment.

Judges Laro and Vasquez dissented, finding that under the IRS's common law arguments they would have allowed a deduction for only the amount actually received by the charity in the redemption. Judges Chiechi and Foley concurred in part and dissented in part. They rejected the majority's interpretation of the assignment agreement under Texas law. Both also found, in separate concurring opinions, that the assignment agreement should govern the property rights transferred to the donees and that under Texas property law, the value of the gift to the taxable donees was $6,910,933 -- the amount specified in the assignment agreement.

The Fifth Circuit reversed the Tax Court's Majority opinion. *See Succession of Charles T. McCord, Jr., et al. v. Comm'r*, 461 F.3d 614 (5th Cir. 2006). The Fifth Circuit emphasized that the fair market value of the interests transferred must be determined on the date of the gift. The Fifth Circuit noted that

> The Majority's key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

Id. at pp. 9-10 (citing *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929); *Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001); *Estate of Smith v. Commissioner*, 198 F.3d 515, 522 (5th Cir. 1999)). Thus, the Fifth Circuit focused on the values of the interests transferred by Mr. and Mrs. McCord as stated in the Assignment Agreement, and not the percentage interests reflected in the donee's Confirmation Agreement that was executed several months after the gifts.

The court noted that the charities retained outside counsel to assist with the transaction, the charities independently analyzed the taxpayer's appraisal and found the methodology appropriate and the value reasonable, and that none of the Tax Court judges found any evidence of an understanding between the taxpayers and the charities that the donee was expected to or had agreed to accept a percentage interest in the partnership with a value less than the full value they were entitled to receive under the assignment agreement. As we will see in later cases, these facts can play an important role in sustaining the viability of a formula transfer.

2. *Christiansen* – Value in Excess of a Defined Amount as Finally Determined Is Disclaimed to Charity (2008/2009)

The application of *Procter* to a defined value formula disclaimer was at issue in the *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008). In *Christiansen*, the decedent's Will left her entire estate to her daughter. The Will further provided that any disclaimed assets would pass 75% to a charitable lead annuity trust (the "CLAT") and 25% to a private foundation (the "Foundation").

Mrs. Christiansen's estate tax return reflected assets having a fair market value of $6.51 million. The principal assets of the Estate were 99% limited partnership interests in two limited partnerships involved principally in the farming and ranching business. Within nine months of Mrs. Christiansen's death, her daughter executed a formula disclaimer, disclaiming a fractional share of the estate exceeding $6.35 million. The formula disclaimer provided, in pertinent part, as follows:

> Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001.

Id. at 5. The formula clause went on to define fair market value "as such value is finally determined for federal estate tax purposes." *Id.*

During the estate tax audit, the IRS asserted that the fair market value of the Estate's assets should be substantially increased. The IRS argued that the assets of both partnerships should be included in Mrs. Christiansen's Estate under I.R.S. § 2036 or, alternatively, that the fair market value of each 99% interest should be increased greatly. Approximately six weeks before trial, the Estate and the IRS reached an agreement whereby (1) the IRS conceded its § 2036 argument, and (2) the parties agreed that the value of the partnership interests should be based on discounts from pro rata net asset value of 37% and 34%, respectively. This agreement increased the size of the gross estate from $6.51 million to approximately $9.6 million.

The settlement caused an additional $3.1 million of value to pass to the CLAT and the Foundation as a result of the disclaimer If those transfers qualified for the estate tax charitable deduction, there would be no additional estate tax. A majority of Tax Court held that the disclaimer was not a qualified disclaimer as to the 75% portion that passed to the CLAT[2]. The majority opined that the disclaimed property did not meet the requirements of § 2518 because Mrs. Christiansen's daughter retained her contingent remainder interest in the CLAT. As to the 25% passing to the Foundation, there was no question that the disclaimer satisfied § 2518. However, the IRS challenged the formula disclaimer on two theories. First, the IRS argued that any increased amount passing to the Foundation was contingent on a condition subsequent. Second, the IRS argued that the formula clause based on values "as finally determined for federal estate tax purposes" was void as contrary to public policy based on *Procter*.

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[2] Judge Swift and Judge Kroupa (the trial judge) dissented from this portion of the opinion. Both opined that the disclaimer was qualified under § 2518.

The Tax Court's decision with respect to the effect of the formula class was unanimous. With respect to the IRS's argument that the transfer pursuant to the formula was contingent on subsequent events and thus violated Treas. Reg. § 20.2055-2(b)(1), the Tax Court noted that the first problem with the argument was that the transfer of property to the Foundation was not a "testamentary charitable contribution." The Tax Court noted that the transfer was the result of a disclaimer which is governed by Treas. Reg. § 20.2055-2(c), and relates back to the decedent's death as if it had been a part of the decedent's Will. The IRS also argued that the increased bequest to the Foundation was contingent because it depended upon the IRS examining the estate tax return and challenging the reported fair market value of the Estate's assets. The Tax Court disagreed, stating

> The regulations speaks of the contingency of 'a transfer' of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer) -- it remains 25% of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of [being] dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity -- for gift, income, or estate tax purposes.

Id. at 15-16.

The IRS also argued that the disclaimer's formula clause was void on public policy grounds because it would discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. The Tax Court rejected the IRS's public policy argument, noting that "we are hard-pressed to find any fundamental public policy against making gifts to charity -- if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." *Id*. at 16-17. Rejecting the IRS's reliance upon *Procter* and its progeny, the Tax Court noted that

> This case is not *Procter*. The contested phrase would not undue a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. If the fair market value of the estate's assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not

> make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

Id. at 17.

The Tax Court further noted that the Foundation's directors as well as executors of a decedent's estate owe fiduciary duties that are enforceable both by the IRS and by the state Attorney General. Thus, the Tax Court found that *Procter* and its progeny did not apply to the formula disclaimer, and that the transfer to the Foundation qualified for the charitable deduction.

The Eighth Circuit affirmed the Tax Court's decision. *Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). With respect to the Commissioner's argument that the gift to charity was contingent, the Eighth Circuit opined that

> The regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer. Rather, it speaks in terms of the existence of *a transfer* at the date of death. See Treas. Reg. § 20.2055-2(b)(1) ("If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."); see also 26 U.S.C. § 2518(a) (providing that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred); S.D. Codified Laws § 29A-2-801(b) (same). Here, all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation. The foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain.
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> * * *
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> It seems clear, then, that references to value 'as finally determined for estate tax purposes' are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a 'qualified disclaimer.' 26 U.S.C. § 2518(a). We find no support for

> the Commissioner's assertion that his challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

With respect to the Commissioner's argument that the formula clause violated public policy because it might reduce the Commissioner's incentive to audit, the Eighth Circuit first noted "that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." In addition, the Eighth Circuit found "no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. [Citations omitted.] Allowing fixed-dollar-amount partial disclaimers supports this broad policy."

Finally, the Eighth Circuit noted that "there are countless other mechanisms in place to ensure that fiduciaries accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." The Eighth Circuit also noted that the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor does not underreport the estate's values and have an interest in serving a watchdog function. Accordingly, the Eighth Circuit noted that the executor owed a fiduciary obligation to both the estate and the foundation and that any self-dealing would be a clear violation of the general state-law fiduciary obligation to put the interest of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing.

3. *Petter* – Value Adjustment Clause Based on Values as Finally Determined With Lifetime Transfer to Charity (2009/2011)

In *Estate of Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (2009), the taxpayer made a lifetime defined-value transfer of units of the Petter Family L.L.C. worth a specific value to trusts for her two children, with the excess portion over that specified value passing to charities, and with the division of the units to be based on values as finally determined for tax purposes. The gift documents required the trusts to transfer any excess units to the charities if the value of the units initially received was finally determined for tax purposes to exceed the defined-value amount. Similarly, the charities agreed to return any excess if the reverse were true.

The IRS argued that the value was higher than reported. Ultimately, the parties settled on a somewhat higher valuation. Thus, the only issues before the Tax Court were whether the defined-value clauses would work as intended by the taxpayer and whether the taxpayer was entitled to a charitable deduction based upon the value of the units passing to charity under the formula.

The Tax Court rejected the public policy arguments raised by the IRS under *Procter*. The Tax Court rejected the mootness argument, determining that any increase in value would result in an increased charitable deduction. The Tax Court pointed out that an adjustment to the value of the units "will actually trigger a reallocation of the number of units between the trust and the foundation under the formula clause. So we are not issuing a merely declaratory judgment." The Tax Court also stated that "[we] simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits."

In response to the IRS's assertion that regulatory formula transfers cited by the taxpayer did not support the defined-value transaction at issue in *Petter*, the Tax Court stated as follows:

> The Commissioner argues that the validity of these other types of formula clauses tells us nothing about the validity of the formula clauses at issue here. He says: 'The absence of an authorization of the formula clause under the instant situation is intentional, as the use of formula clauses in this situation is contrary to public policy, and frustrates enforcement of the internal revenue laws.' He seems to be saying that Congress and the Treasury know how to allow such gifts, and their failure to explicitly allow formula clauses under the Code and regulations governing gift tax means that they have implicitly banned them. But the Commissioner does not point us to any Code section or regulation generally prohibiting formula clauses in gift transfers, or denying charitable deductions for donors who use these formula clauses in transfers to charities. The Commissioner also fails to address the argument that Anne is actually making; the mere existence of these allowed formula clauses, which would tend to discourage audit and affect litigation outcomes the same way as Anne's formula clause, belies the Commissioner's assertion that there is some well-established public policy against the formula transfer Anne used.

The Tax Court thus upheld the defined-value structure. In its opinion, the Tax Court drew something of a bright line between *Procter*-style savings clauses, on the one hand, and formula clauses like *Petter*, *Christiansen*, and *McCord*, on the other hand. The Tax Court noted that the "distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter*. . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."

The Ninth Circuit affirmed the Tax Court's decision. *Estate of Petter v. Comm'r*, 598 F.3d 1191 (9th Cir. 2011). The Ninth Circuit rejected the IRS's argument that the adjustment future of the formula clause makes the "additional charitable gifts subject to the occurrence of a condition precedent." Noting that "a condition precedent is one that must occur before a transfer to charity 'become[s] effective,'" the court held that Mrs. Petter's transfers became effective immediately upon her execution of the transfer documents and delivery of the units. The only possible open question was the value of the units transferred, not the transfers themselves. The court further opined that while the reallocation clauses in the transfer agreements required the trusts to transfer excess units to the foundations if it was later determined that the units were undervalued, "these clauses merely enforce the foundations' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified dollar amount. The court stated that the IRS's determination that the LLC units had a greater fair market value than what the Moss Adams appraisal said they had in no way grants the foundations' rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already entitled to receive. The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known."

4. ***Hendrix – McCord*-Like Transaction in the Tax Court Again (2011)**

The issue in *Hendrix v. Comm'r*, T.C. Memo 2011-133 (June 15, 2011), was whether a defined value formula clause contained in an assignment agreement determined the fair market value of the stock in the John H. Hendrix Corp. ("JHC") that Mr. and Mrs. Hendrix transferred on December 31, 1999, to family trusts and to a charitable foundation. The Tax Court determined that the formula clauses were reached at arm's length and that they are not void as contrary to public policy.

The Hendrix's principal asset was the stock of JHC. On December 31, 1999, the Hendrixes, the trustees of trusts created for the benefit of their daughters, and the Greater Houston Community Foundation (the "Foundation") executed an assignment agreement that irrevocably assigned 287,619.64 shares of each of Mr. and Mrs. Hendrix's JHC nonvoting stock to the trusts and to the Foundation. Mr. and Mrs. Hendrix utilized a formula that assigned (1) shares having a fair market value as of the effective date equal to $10,519,136.12 to GST trusts for the initial benefit their two daughters, and (2) any remaining portion of the assigned shares to the Foundation for the benefit of donor advised funds that the Hendrixes had established. The assignment agreements, similar to those used in *McCord*, defined fair market value in the same manner as defined under the gift tax Treasury Regulations. The assignment agreements also required the trusts to proportionately pay any gift taxes imposed as a result of the transfer. The trustees signed promissory notes obligating the trustees to pay $9,090,000 to each petitioner.

On the same day, a second set of assignment agreements were executed containing the same terms as the first set of assignment agreements, except that Mr. and Mrs. Hendrix each irrevocably transferred 115,622.21 shares of the JHC nonvoting stock to his or her corresponding "issue" trust and to the Foundation, and the fair market value

of the stock transferred to the issue trusts was set at $4,213,710.10. The second set of assignment agreements directed the trustees to deliver to each petitioner a note in the amount of $3,641,233.

The assignment agreements provided Mr. and Mrs. Hendrix with no right or responsibility for allocating the shares among the transferees on a per share basis. The allocation was left to the transferees. Taxpayers had an appraisal prepared and after the transfer, their counsel sent the appraisal to the Foundation and its counsel. The Foundation, consistent with its policy regarding receipt of hard–to–value assets, retained another independent appraisal firm to review the appraisal. The Foundation's appraiser concluded that the appraisal was "reasonable and fair." One month later, the Foundation and the trustees entered into confirmation agreements that allocated the JHC shares amongst the recipients according to the fair market value of $36.56 per share listed in the appraisal. Mr. and Mrs. Hendrix were not parties to the confirmation agreements.

The Tax Court noted that the case was appealable to the Fifth Circuit, and that it was obliged to follow *Succession of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), *rev'g.*, 120 T.C. 358 (2003). The Tax Court held that *Succession of McCord* was dispositive of the case except to the extent that Respondent argued that (1) the formula clauses were not the result of an arm's length transaction or (2) the formula clause was void as contrary to public policy.

The Tax Court began its arm's length transaction analysis by noting that "generally, a taxpayer may structure a transaction in a manner that minimizes or avoids taxes by any means the laws allow." The Tax Court noted that it may disregard the form of a transaction in favor of its substance whenever collusion, an understanding, a side deal, or other indicia that the transaction was not at arm's length exists. The Tax Court also noted that the disregard of a transaction for lack of substance cannot be based on mere suspicion and speculation arising from the fact that a taxpayer engaged in estate planning.

The Tax Court rejected Respondent's argument that the formula clause was not at arm's length because Mr. and Mrs. Hendrix and their daughters (or their trusts) were close and lacked adverse interests, the daughters benefitted from the petitioners' estate plan, and the clauses were not thoroughly negotiated. The Tax Court held that the mere fact that Mr. and Mrs. Hendrix and their daughters were close and that the petitioners' estate plan was beneficial to them does not necessarily mean the formula clauses failed to be reached at arm's length. The Tax Court also opined that a finding of negotiation or adverse interests is not an essential element of an arm's length transaction. The Tax Court noted, however, that there was nothing in the record to persuade the Tax Court that either the formula clauses were not subject to negotiation or that the petitioners and the daughters' trusts lacked adverse interests.

The Tax Court also declined to accept Respondent's request to find collusion between the Hendrixes and the Foundation. The Tax Court found that the creation of the donor advised fund at the Foundation did not diverge from their usual course of donation and that the Foundation had accepted various potential risks incident to its receipt of the

gifts, including a loss of the Foundation's tax-exempt status if it failed to exercise due diligence as to the gifts. The Tax Court also noted that the Foundation, which manages nearly $270 million of assets, exercised its bargaining power when its counsel insisted on certain provisions being added to the assignment agreements. The Tax Court found it important that the Foundation was represented by independent counsel and the Foundation hired an independent appraiser to review the petitioners' appraisal. Finally, the Tax Court noted that the Foundation had fiduciary obligations under state and federal law to ensure that it received the number of shares it was entitled to receive under the formula clauses.

The Tax Court also rejected Respondent's *Procter*-based public policy argument, noting that the formula clauses do not immediately and severely frustrate any national or state policy. To the contrary, the "fundamental public policy here is one of encouraging gifts to charity, and the formula clauses support that policy."

The Tax Court found the Hendrix transaction to be distinguishable from *Procter* and its progeny because the formula clauses imposed no condition subsequent that would defeat the transfer. The Tax Court concluded the formula clauses furthered the fundamental public policy of encouraging gifts to charity, citing *Estate of Christiansen v. Comm'r*, 130 T.C.-1 (2008). The Tax Court found no legitimate reason to distinguish the formula clauses in the *Hendrix* transfers from the disclaimer in *Christiansen*, and declined to do so.

5. *Wandry* – Value Adjustment Clause Based on Values as Finally Determined, and No Third Party (2012)

In *Estate of Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012), the Tax Court upheld a dollar value formula transfer clause transferring LLC units. What is unique about this case is that it did not involve a charity or any other tax-free entity.

On January 1, 2004, the taxpayers decided to give LLC units in amounts equal to their (1) $1 million gift tax exemption, to be divided equally among each of their four children, and (2) $11,000 annual exclusion to each of their four children and five grandchildren. Following the advice of their counsel, they made gifts of LLC units under a formula specifying that the LLC units for federal gift tax purposes equaled each of the specific dollar amounts. The transfer documents provided as follows:

I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000

Name	Gift Amount
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

After obtaining an independent appraisal, the LLC's accountant adjusted the capital accounts to reflect the transfers. The taxpayers filed gift tax returns reporting each gift on a percentage basis. However, the dollar value of each gift corresponded to the value of the interest each taxpayer desired to transfer, and the percentage interests were based on the value of a 1% interest reflected in the appraisal attached to their gift tax return.

After an IRS audit, the parties agreed to a higher value for the units transferred. The IRS claimed additional gift tax was due. The IRS asserted that the value of the gifts should be equal to the percentages listed in the gift tax returns multiplied by the stipulated value of a 1% interest. The taxpayer argued that the dollar value formula controlled and required a reallocation of units, which did not change the value of the units transferred to the children and grandchildren.

a. The Tax Return Position Was Not an Admission that Percentage Interests Were Transferred

Relying on *Knight v. Commissioner*, 115 T.C. 506 (2000), the IRS argued that the gift descriptions contained in the gift tax returns were binding admissions that the taxpayers had transferred fixed percentage interests. The court disagreed, noting that in *Knight*, the taxpayers disregarded the formula by arguing that the gifts were actually worth less than the dollar value included in the transfer documents. The court contrasted *Knight* with the fact that the *Wandry* taxpayers believed that they had made dollar value gifts equal to the specified dollar amounts, noting "[a]t all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units." The court further noted that the gift tax returns and the schedules attached to them reported gifts of dollar amounts. The court found that the description of the dollar value transfers and the appraisal report attached to the gift tax returns demonstrated petitioners' consistent intent that dollar value gifts were intended.

The IRS also argued that the capital accounts controlled the nature of the gifts and the capital accounts reflected gifts of fixed percentage interests. The court rejected this argument, opining that the "facts and circumstances determine Norseman's capital accounts, not the other way around." The court pointed out that the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect prior years.

b. The Formula Clause Was Not a Void Savings Clause

The IRS next argued that the formula contained an improper savings clause in violation of the public policy principles espoused in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Relying on its analysis in *Estate of Petter*, the Tax Court drew a distinction between a "savings clause" (*Procter*) and a "formula clause" (*Petter*), noting that

> A savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a 'formula clause' is valid because it merely transfer a 'fixed set of rights with uncertain value.' The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

The court opined that it was inconsequential that the adjustment clause reallocated membership units among the taxpayers and the donees, rather than to a charitable organization, because the reallocation did not alter the transfer. As a result of the transfer, each donee was entitled to a predefined percentage interest in the LLC expressed through a formula. The transfer documents did not allow the taxpayer to take back units; rather, the transfer documents provided for the allocation of the units among the donees and the taxpayers.

The court's public policy analysis went on to address the specific public policy concerns raised in *Procter*. The court first stated that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. The court also noted that there are mechanisms outside of IRS audits to ensure accurate valuation reporting. As it stated in *Petter*, a judgment in the gift tax case regarding value will reallocate units among the donors and donees. Therefore, the court is not ruling on a moot case or issuing merely a declaratory judgment.

Finally, the court addressed the absence of a charity in the formula transfer. The court noted that while the charitable aspect of the formula clause contributed to the court's decision in *Petter*, it was not determinative. Accordingly, the court stated that the lack of charitable component in a formula clause does not result in a "severe and immediate" public policy concern as required by *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966).

On November 13, 2012, the IRS announced that it did not acquiesce in the *Wandry* decision.

D. Potential Donees of the "Excess Amount" Under a Formula Clause

For a formula clause to be successful, the amount in excess of the defined value must pass to a person or entity that will not result in the imposition of transfer taxes. *McCord*, *Hendrix*, *Petter* and *Christiansen* all involved transfers of the excess amount to charity. However, some clients are not charitably inclined, yet they still desire some level of certainty with respect to their transfer.

Wandry involved the transfer of a specified dollar amount of assets, with any "overage" being retained by the transferor. Planners have also utilized QTIP trusts and GRATS as recipients of the non-taxable portion of the transfer.

1. Public Charity/Donor Advised Fund

As noted above, public charities were involved in each of the transactions at issue in *McCord*, *Hendrix*, and *Petter*. Preference of the independent charity in each of those cases were important attributes in the courts' decisions.

Parties to the transaction must be aware that the charity has independent obligations to the state's attorney general and to the Internal Revenue Service that provide the charity with the obligation and incentive to "audit" the transaction.

Public charities are subject to private inurement rules and excess benefit rules. Section 501(c)(3) requires that a public charity ensure that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual . . . . I.R.C. § 501(c)(3). The transferor should expect the charity to be on the lookout for private inurement, both with respect to the initial transaction as well as the operation of the entity in the event that the charity holds its interest long term. The IRS has the ability to sanction a charity violating the private inurement rules by (1) revoking its tax-exempt status or (2) imposing intermediate sanctions. Treas. Regs. § 1.501(c)(3)-1(c)(3)-1(c)(2).

The intermediate sanctions provisions authorize the IRS to impose a 10% penalty on the charity's managers who authorized an excess benefit transaction and an escalating series of penalties against disqualified persons receiving the excess benefit. An excess benefit transaction is one involving an economic benefit passing from the charity to a disqualified person in excess of any consideration received by the charity. The taxes under the intermediate sanctions rules are draconian, with a first-tier tax of 25% being imposed on the disqualified person receiving the prohibited benefit, a second tier tax of 200% being imposed on a disqualified person when an excess benefit transaction is not corrected within a specified period, and a tax of 10% of the excess benefit imposed on the organization's managers who agreed to the transaction. Each of these taxes is subject to abatement under I.R.C. § 4962 if reasonable cause and the absence of willful neglect can be shown and corrective action is taken within 90 days of the notice of deficiency. The transferor, the transferor's family, the entity, and any other party involved in the transaction may be considered disqualified persons for purposes of imposition of intermediate sanctions.

The transactions in *McCord*, *Hendrix*, and *Petter* all involved donor advised funds of a public charity. The donor advised fund has the same private inurement and excess benefit issues discussed above. The primary benefit to the donor advised fund is the ability for the family to retain some level of control over the charitable purpose of the assets transferred to the charity through the recommendation of potential charitable donees.

2. Private Foundation

The private foundation is a permissible charitable transferee of an interest under a formula clause, and was one of the recipients of interests in the *Christiansen* case. The private foundation rules prohibiting self-dealing (I.R.C. § 4941), excess business holdings (I.R.C. § 4943), jeopardizing investments (I.R.C. § 4944), and taxable expenditures (I.R.C. § 4945), provide substantial barriers to using the private foundation as a donee under a formula clause.

3. Lifetime QTIP Trusts

Because the transfer of assets to a QTIP trust is exempt from gift tax, many planners have coupled a defined value transfer to taxable transferees with a gift of the value above the specific dollar amount to a QTIP trust. Testamentary formula transfers to QTIP trusts have been used for decades, and the theory underlying the courts' decisions in *McCord*, *Hendrix*, *Petter*, and *Christiansen* should apply equally to a transfer to a QTIP trust as it does to a charity. But if (1) the trustee of any trust receiving the defined value portion of the transfer (such as an IDGT) is the same as the trustee of the QTIP trust, or (2) the remainder beneficiaries of the QTIP trust are the same persons as those receiving the defined value portion, the IRS may question whether a party with the incentive (and the fiduciary obligation) to enforce the terms of the formula transfer really exists. The obvious response is the QTIP trustees have an independent fiduciary obligation to all beneficiaries of the trust to ensure the proper valuation of the interests being transferred. In other words, the trustees of the QTIP have an obligation to protect

the interests of the trust similar to the charity's obligation to protect its interests. *See*, *e.g.*, *Estate of Duncan v. Comm'r*, T.C. Memo 2011-255 (Oct. 31, 2011). To avoid this argument, planners should consider (1) having different trustees of any trust receiving the defined value portion and the QTIP, and (2) having remainder beneficiaries of the QTIP who are different from the recipients of the defined value portion of the transfer.

4. Grantor Retained Annuity Trusts

Another commonly used technique is to have the "non-taxable" portion of the transaction pass to a grantor retained annuity trust. One of the benefits of the GRAT is the formula provisions are substantially similar to those contained and blessed by the Treasury in the Regulations contained under I.R.C. § 2702. The IRS may make arguments similar to those outlined above with respect to lifetime QTIP transfers. As with lifetime QTIPs, the parties might consider (1) having different trustees of any trust receiving the defined value portion and the GRAT, and (2) having remainder beneficiaries of the GRAT who are different from the recipients of the defined value portion of the transfer.

E. Gift Tax Reporting

When using a formula adjustment clause based on values as finally determined for gift tax purposes, a gift tax return for the calendar year of the transaction should be filed. My preference is to lay out the formula provisions in detail, as well as attaching copies of the appraisal and the transaction documents as exhibits to the return. Attaching all of this information fully discloses the transaction to the IRS and begins the statute of limitations running on the determination of final gift tax values. If the formula clause is based on gift tax values as finally determined, it would seem that filing the gift tax return is required to achieve "finality" on gift tax values.

If transfers are not reported on the gift tax return, the IRS will argue that the statute of limitations has not started to run and the IRS may raise the valuation at issue at any time during the transferor's lifetime or upon death. Even where the taxpayer asserts that no gift occurred as the result of a sale transaction, the Treasury Regulations provide that adequate disclosure is required to start the gift tax statute of limitations running. Regulations provide that a non-gift transfer will be adequately disclosed on a gift tax return if the following information is provided:

(i) a description of the transferred property and any consideration received by the transferor;

(ii) the identify of, and relationship between, the transferor and each transferee;

(iii) if the property is transferred in trust, the trust tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instruments; and

(iv) a statement describing any position taken that is contrary to any proposed, temporary or final Treasury Regulations or Revenue Rulings published at the time of the transfer.

Treas. Regs. § 301.6501(c)-1(f)(2)(i)-(v). The Treasury Regulations also require an explanation regarding why the transfer is not a transfer by gift. Treas. Regs. § 301.6501(c)-1(f)(4).

The transaction should be reported consistently with the formula to avoid the argument faced by the taxpayers in *Knight v. Comm'r*, 115 T.C. 506 (2000) (IRS successfully argued that the gift descriptions contained in the gift tax returns were binding admissions that the taxpayers had transferred fixed percentage interests instead of interests pursuant to a formula). That is why I prefer to see the formula reflected in the gift tax return schedules, with an explanation of how the percentage interest allocated was derived (*i.e.*, based on the attached appraisal), and with copies of the appraisal and the transaction documents attached.

F. Income Tax Issues

If the charity receives an interest in the entity pursuant to the formula, the value of the interest transferred to charity should be deductible for income tax purposes (subject to percentage limitations and reduction rules).

For transactions based on values "as finally determined," there will be an initial allocation of units based upon either an appraisal or agreement. If the value is "finally determined" to be different from the initial allocation (as was the case in *Petter*), the parties will need to reallocate income and expense items retroactive to the date of the initial transfer. Likewise, it may be necessary to file amended returns to account for the fact that the parties were entitled to the proportionate interest finally determined at the time of the initial transfer. That is because all income items and deduction items would be retroactive to the date of the initial transfer.

Because the three-year statute of limitations would apply, the parties to the transaction (particularly the taxable donees and the entity) should consider filing protective claims for refund before the expiration of the three-year statute of limitations to preserve the right to amend income tax returns in the event that it is determined that the interest received by the taxable transferee is less than what was initially anticipated. In addition, the transferor should consider filing a protective claim for refund in the event that the charity receives a gift greater than the amount anticipated to be received in the initial allocation preserve the ability to obtain a larger income tax charitable deduction than was initially anticipated for the year of transfer.

Because the *McCord*-type transaction is not based on values as finally determined, any change in value of the asset transferred by a court does not affect the allocation of the units. Thus, no amended income tax returns will need to be filed by the recipients of the transferred interests.

VI. GRAEGIN NOTES

Estate of Duncan v. Comm'r

In *Estate of Duncan v. Comm'r*, T.C. Memo 2011-255 (Oct. 31, 2011), the Tax Court considered whether the Estate could deduct interest incurred when a trust, which was the residual beneficiary of the Estate and whose assets were included in the gross estate, borrowed funds to enable the Estate to pay Federal estate tax.

Vincent J. Duncan, Sr. ("Mr. Duncan") died on January 14, 2006. His assets were primarily held in a revocable trust (the "2001 Trust"), the principal asset of which was interest in an oil and gas company. Mr. Duncan's estate obligations and taxes were to be paid by the 2001 Trust after death. The 2001 Trust subsequently passed to trusts created for the benefit of each of his children.

Mr. Duncan was also the beneficiary and held a power of appointment over a trust created by his father which held interests in the oil and gas entity (the "Walter Trust"). Mr. Duncan exercised his power of appointment to appoint the assets of the Walter Trust to trusts designated for each of his children. The children's trusts were similar to those created under the 2001 Trust, except that each primary beneficiary had a limited power of appointment that allowed for the distribution of trust corpus to a descendant of Mr. Duncan or to charity. The Walter Trust and the 2001 Trust had identical co-trustees.

The Estate estimated that its Federal estate tax liability would be approximately $11.1 million and determined that the 2001 Trust also needed to retain a cash reserve to satisfy the Estate's other obligations (*e.g.*, ongoing administration expenses and amounts that Mr. Duncan owed to his former spouse under a divorce decree). The co-trustees of the 2001 Trust decided to borrow funds to meet its obligations. The 2001 Trust borrowed the funds from the Walter Trust pursuant to a secured promissory note with a face amount of $6.5 million. Interest was payable at 6.7 percent, compounded annually, with interest and principal payable at the end of the 15-year term. The co-trustees utilized a 15-year term loan because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The co-trustees obtained the 6.7 percent interest rate from Northern Trust's banking department. The note expressly prohibited the prepayment of interest and principal. When the loan was made, the long-term AFR rate was 5.02 percent and the prime rate of interest was 8.25 percent. The Estate paid $11,075,515 of estimated tax nine months after Mr. Duncan's death.

The Estate claimed a $10,653,826 deduction for the interest owed to the Walter Trust over the 15-year term of the loan. The Commissioner challenged the deduction under § 2053.

The Court first addressed the question of whether the loan was a bona fide debt. The Commissioner argued that the loan was not a bona fide debt based upon its analysis of 15 factors taken from the *Estate of Rosen v. Comm'r*, T.C. Memo. 2006-115. The Court noted that the factors taken from *Estate of Rosen* were irrelevant because they were used to decide whether a purported loan should be classified as equity rather than debt.

In this case, the Court reasoned that the Walter Trust and the 2001 Trust were not related in a way in which one can be considered the owner of the other. The loan therefore cannot be classified as equity even if it is not bona fide.

The Court noted that the ultimate question regarding whether the debt was bona fide is whether there was a genuine intention to create a debt with a reasonable expectation of repayment and whether that intention fit with the economic reality of creating a debtor-creditor relationship, citing *Litton Bus. Sys., Inc. v. Comm'r*, 61 T.C. 367, 377 (1973). The Commissioner argued that there was no economic consequence to the loan because the borrower and the creditor trusts are identical, having the same trustees and the same beneficiaries. The Commissioner also claimed that the Walter Trust had no reason to demand repayment because the detriment to it would be offset by the gain to the 2001 Trust. The Court rejected this argument, noting Illinois law required the trustee of two distinct trusts to maintain a trust's individuality. The Court further noted that there is no basis in Federal tax law for treating the 2001 Trust and the Walter Trust as a single trust.

The Commissioner also asserted that the loan was not actually and reasonably necessary because (1) the 2001 Trust could have instead sold illiquid assets to the Walter Trust, and (2) the terms of the loan were unreasonable. Relying on *Estate of Black*, 133 T.C. 340 (2009), the Commissioner argued that the 2001 Trust did not need to borrow money because it could have sold assets to the Walter Trust at full fair market value. The Court noted that the Commissioner misinterpreted the holding in *Estate of Black*, stating, "[w]e did not hold that the loan was unnecessary because the estate could have sold stock. We held the loan was unnecessary because the estate would have had to sell the stock under any circumstance. The sale of the stock was inevitable, and the estate therefore could not have entered into the loan for the purpose of avoiding that sale." (Emphasis in original.)

The Court also noted that the 15-year term was reasonable and that the co-trustees could not, at the time the loan was made, be reasonably certain that the 2001 Trust would have enough money to pay the Estate's Federal estate tax and administration expenses within three years (the period to which the Commissioner proposed to limit the Estate's interest expense deduction). The accountant for the oil & gas company credibly testified that the volatility in the price of oil and gas made future income difficult to predict. The Court noted that while the Estate may have generated enough cash to repay the loan after three years, the benefit of hindsight would not be used to second guess the co-trustees' judgment when they were acting in the best interest of the Estate.

The Court also rejected the Commissioner's claim that the interest rate of 6.7 percent was excessive. The Court disagreed that the co-trustees should have used the long-term AFR rate because that rate did not represent the 2001 Trust's cost of borrowing. Summarily dismissing the Commissioner's claim that the interest rate was unreasonable since no negotiations had taken place, the Court noted that the co-trustees reasonably asked Northern Trust's banking department for the market rate of interest, and that formal negotiations would have amounted to "nothing more than playacting, and to impose such a requirement on the co-trustees would be absurd."

Finally, the Court noted that the amount of interest expense was ascertainable with reasonable certainty based on the premise that the Walter Trust and the 2001 Trust are distinct trusts to be administered separately. If interest rates rose to the point where the Walter Trust would benefit from early repayment, the co-trustees of the 2001 Trust could not direct an early repayment because this would harm the 2001 Trust. If interest rates did not rise, the co-trustees could not allow repayment because that would reduce the Walter Trust's interest income. Accordingly, the Court found that the total interest over the life of the loan was deductible.

Koons v. Comm'r

In *Koons v. Comm'r*, T.C. Memo 2013-94 (Apr. 8, 2013), the Tax Court considered whether the Estate could deduct approximately $71 million of projected interest expense on a loan from an entity ("CI LLC") in which the decedent's revocable trust owned a 70.42% voting interest. CI LLC had approximately $200 million of liquid assets, which were the proceeds of a recent sale of a closely held Pepsi Cola bottling business. CI LLC's long-term business plan, however, was to reinvest those assets, including purchasing substantial operating businesses. Exercising their business judgment, the trustees of the revocable trust and the managers of CI LLC determined that it was in the trust's and CI LLC's best interest for the trust to borrow the funds rather than to have a pro-rata distribution or a redemption of CI LLC interests.

The Tax Court denied the interest deduction. The Court held that because the revocable trust had 70.42% voting control over CI LLC, it "had the power to force CI LLC and its board of managers to make a pro-rata distribution to its members, including the Revocable Trust itself. The Revocable Trust's ability to force CI LLC to distribute its assets made it unnecessary for the Revocable Trust to borrow from CI LLC."

VII. SECTION 2519

***Estate of Kite v. Comm'r,* T.C. Memo. 2013-43 (Feb. 7, 2013)**

In *Estate of Kite*, the Tax Court (Judge Paris) addressed issues involving (1) the application of § 2519 to a QTIP trust's creation of closely held entities, and (2) the sale of interests for a private annuity.

The decedent ("Mrs. Kite") was the current income beneficiary of numerous trusts, four of which were at issue in the case. The four trusts were: two QTIP trusts, one marital deduction trust, and Mrs. Kite's revocable trust. On December 31, 1996, the trusts formed Brentwood Limited Partnership, an Oklahoma limited partnership ("Brentwood"). The trusts received limited partnership interests in exchange for their contributions. Brentwood's general partner was Easterly Corp., an Oklahoma corporation ("Easterly Oklahoma") organized in December 1996 and wholly owned by Mrs. Kite and her children (either individually or through trusts).

In January of 1997, Mrs. Kite, as trustee of her trusts, transferred to her children approximately one-third of her Brentwood limited partnership interests. She also

transferred to her children a portion of her Easterly Oklahoma shares. Mrs. Kite reported the transfers as gifts in 1997.

In 1998, Brentwood and Easterly Oklahoma reorganized in Texas seeking a more advantageous state tax jurisdiction. Brentwood merged into Baldwin Limited Partnership ("Baldwin"), a Texas limited partnership. Easterly merged into Easterly Corp., a Texas corporation ("Easterly Texas"). The ownership interests remained the same.

In May of 1998, Mrs. Kite, through her trusts, sold her remaining interest in Baldwin to her children for fully secured promissory notes (the "Baldwin Notes"). The Baldwin Notes required the Kite children (or their trusts) to make quarterly payments of principal and interest through May 1, 2013. Mrs. Kite, as the current income beneficiary of her trusts, received the payments on the Baldwin Notes.

On December 31, 2000, Mrs. Kite's trusts contributed the Baldwin Notes and Easterly Texas contributed assets to form Kite Family Investment Co., a Texas general partnership ("Kite Investment"). Mrs. Kite's trusts collectively held a 99% interest in Kite Investment and Easterly Texas held a 1% interest. Easterly Texas was the manager of Kite Investment.

On March 28, 2001, Mrs. Kite replaced the trustees of the QTIP trusts and the marital deduction trust with the Kite children retroactive to January 1. The Kite children, as trustees, contemporaneously executed documents to terminate the trusts effective January 1, 2001. The assets of the trusts, which consisted solely of Kite Investment general partnership interests, were transferred to Mrs. Kite's lifetime revocable trust. The next day, Baldwin, which was wholly owned by the Kite children and their trusts, contributed approximately $13.5 million of assets to Kite Investment, more than doubling Kite Investment's previous capital and diversified its holdings. In return, Baldwin received a 55.8215% general partnership interest in Kite Investment. Mrs. Kite's lifetime revocable trust and Easterly Texas owned Kite Investment's remaining interests.

On March 30, 2001, Mrs. Kite sold her interest in Kite Investment to her children (or their trusts) for three private annuities. The annuity agreements provided that the Kite children would begin payments 10 years after the effective date of the annuity agreements. If Mrs. Kite died within the 10-year deferral period, her annuity interest would terminate and her interest in Kite Investment (and indirectly her interest in the Baldwin Notes) would be effectively removed from her gross estate. However, if Mrs. Kite survived the 10-year deferral period, her children would be personally liable for the annuity payments due on each annual payment date. If Mrs. Kite survived for 13 years or longer, her children could be insolvent after the first three years of payments, in view of their then-current personal assets. Mrs. Kite was 74 years old at the time of the transactions, and her doctor certified to her longevity and health.

1. The Private Annuity Agreements

The Commissioner argued that the transfer of Kite Investment interests for an unsecured private annuity (1) were disguised gifts, (2) lacked substance, and (3) were

illusory. The Court rejected these arguments, noting that even though Mrs. Kite was elderly and her medical expenses were increasing, the private annuity exchange was at full fair market value. Relying on *Estate of McLendon v. Commissioner*, the Court held that Mrs. Kite could rely on the IRS actuarial tables under I.R.C. § 7520 in valuing the annuity interest. The opinion and testimony of Mrs. Kite's physician indicated that Mrs. Kite, 75 years old at the time of the annuity agreements, had at least a 50% possibility of surviving for at least 18 months. The Commissioner failed to present any contrary evidence. The Court noted that as demonstrated by the *McLendon* case, increased medical costs and home healthcare did not prove a terminal illness or other incurable disease for purposes of § 7520. The Court noted that "unlike the private annuity agreements in *Estate of Hurford*, the annuity agreements between Mrs. Kite and her children were enforceable, and the parties demonstrated their intention to comply with the terms of the annuity agreements."

2. Section 2519

The Commissioner argued that the creation of Brentwood triggered § 2519 with respect to the assets contributed by the QTIP trusts to Brentwood. The Commissioner asserted that under § 2056(b)(7), any disposition of a QTIP qualifying income interest during the income beneficiary's lifetime by gift, sale or otherwise will result in the QTIP assets being subject to gift tax (in lieu of a qualifying income interest). Relying on the Regulations under § 2519, the Tax Court concluded that the QTIPs' contribution of assets to Brentwood did not trigger § 2519. The Court opined that "[n]ot included as a disposition for purposes of section 2519 is the conversion of QTIP into other property in which the surviving spouse has a qualifying income interest for life." The Tax Court quoted Treas. Reg. § 25.2519-1(f), which provides "that the sale and reinvestment of assets of a trust holding QTIP is not a disposition of the qualifying income interest, provided that the surviving spouse continues to have a qualifying income interest for life in the trust after the sale and reinvestment."

However, the Court did conclude that the liquidation of the QTIP trusts and subsequent sale of Mrs. Kite's interests in Kite Investment was contrary to the QTIP rules and "was part of a prearranged and simultaneous transfer of the QTIP trust assets . . . ." The Court held that the termination of the QTIP trusts and the sale of Mrs. Kite's interests in Kite Investment was part of a single transaction for purposes of § 2519 and was subject to Federal gift tax to the extent of the entire value of the property transferred, less the value of Mrs. Kite's qualifying income interest, as to which she made no gift.

VIII. NET/NET GIFTS

In *Steinberg v. Comm'r*, 141 T.C. No. 8, (September 30, 2013), the donor (who was 89 years old) made gifts of cash and marketable securities to her four daughters. The daughters agreed to pay the gift tax and also agreed that if their mother died within three years, they would pay the additional estate tax liability resulting from the addition of the gift tax to her gross estate under § 2035(b). In reporting the gifts, the donor subtracted both the amount of the gift tax (a net gift pursuant to Rev. Rul. 75-72) and the present value of the daughters' undertaking to pay any estate tax related to the gift under

§ 2035(b). The IRS assessed a deficiency, allowing net gift treatment but disallowing the "net, net gift" deduction. The donor challenged the deficiency in the Tax Court.

The IRS filed a motion for summary judgment in the Tax Court, citing the Tax Court's 2003 decision in *McCord v. Comm'r* (which had been reversed by the Fifth Circuit Court of Appeals). The IRS argued that the donees' assumption of potential section 2035(b) estate tax liability was worthless and provided no benefit to the donor. Because the assumption was worthless, it was not consideration for a gift under the estate depletion theory of gift tax, the IRS argued. Under that theory, a donor receives consideration in money or money's worth if the donor's estate receives some benefit from the consideration offered for a gratuitous transfer.

The Tax Court, in a split decision, denied the IRS's motion. The majority declined to agree with the IRS that as a matter of law, the donees' obligation to pay the tax did not result in any benefit to the donor. The majority opinion also overruled the Tax Court's decision in *McCord* and held that the value of the gift may be reduced by the present value of the donee's contingent obligation to pay estate taxes. The majority opined that the daughters' commitment to pay the § 2035(b) estate tax liability was not "too speculative as a matter of law" to be reduced to a monetary value. The likelihood that the donor would survive three years was actuarial ascertainable, and a willing buyer would assume the existing marginal rates and exemption amounts would remain in place. Therefore, the majority refused to rule as a matter of law that the taxpayer had not established an appropriate method of valuing the contingent incremental estate tax liability.

Six judges issued a separate opinion, concurring with the result but not the reasoning of the majority. The concurring opinion found that it was premature to overrule *McCord* on the ground that the daughters' commitment was too speculative because the IRS had not raised that issue in its motion. With respect to the estate depletion argument, the concurring opinion agreed that the motion for summary judgment should be denied, but on different grounds. The IRS had argued that the daughters' commitment to pay the § 2035(b) estate tax amounted to an agreement with respect to the apportionment of taxes in their mother's estate and that the same result would occur under applicable state law absent the agreement. Thus, no benefit was received by the donor. The concurrence noted that a fact issue existed as this would be true only if the daughters were in fact residuary legatees of the estate, and only if their commitment did not provide an enforcement mechanism not otherwise existing under state law. The concurrence noted, however, that if the only function of the daughters' commitment was an enforcement mechanism for an existing liability, this would substantially reduce the value of the commitment to pay taxes.

Several problems exist with respect to the concurring analysis. First, part of the consideration for the transfer was the assumption of the obligation to pay the § 2035(b) estate tax. It does not matter whether that obligation is contractual or imposed by statute. Absent contract (or statute), it is an obligation that would have otherwise rested with the donor or her estate. Second, if the willing buyer/willing seller test assumes hypothetical buyers and sellers, how can the actual recipient be relevant to the analysis? The

concurring opinion appears to be a family attribution argument. That is, even assuming the daughters are the beneficiaries of the estate under the donor's current will, that should be irrelevant for valuation purposes. The concurring opinion addressed not only on the property rights exchanged, but made assumptions about other rights possessed (or not) by the daughters (*i.e.*, the existence of an expectancy under the will).

IX. VARIOUS VALUATION ADJUSTMENTS

A. Unrealized Capital Gains

In *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998), the Tax Court recognized the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation for the first time since the repeal of the General Utilities doctrine. At issue in *Davis* was the gift tax value of two 25 share blocks of stock (of the total of 97 shares) of A.D.D. Investment & Cattle Company ("ADDIC") given to each of two sons. ADDIC was a family owned holding company, the assets of which included over 1% of the issued and outstanding common stock of Winn-Dixie, listed on the New York Stock Exchange, and assets related to ADDIC's cattle operations. ADDIC assets had a total built-in capital gains tax liability of $26.7 million, about 96% of the gain being attributable to its Winn-Dixie stock. The Court allowed a $9 million adjustment for built-in capital gains tax, representing approximately 1/3 of the total capital gains tax liability on all of the corporate assets. The petitioner's two experts and the IRS's expert (but not the IRS) believe that an adjustment was warranted -- that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock. The dispute was over the amount of the adjustment. The Court found that the full amount of built-in tax liability could not be taken as a discount when there was no evidence that ADDIC planned to liquidate or sell its assets. The Court concluded that a $9 million discount was properly included as a part of the lack of marketability discount to be applied in value in the two blocks of stock.

Following quickly on the heels of the *Davis* decision was the Second Circuit's decision in *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998), reversing a memorandum decision of the Tax Court. The Appeals Court found that the Tax Court erred in not considering the built-in capital gains tax as a liability and remanded the case back to the Tax Court to decide on the amount of the liability. This reversal was the last nail in the coffin of the notion that built-in capital gains taxes should not be considered in valuing C corporations. The IRS has acquiesced in *Eisenberg* "to the extent that it holds that there is no legal prohibition against such a discount." AOD 1999-001.

In *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383 (1999), the Tax Court again allowed a discount for unrealized capital gains. In *Jameson*, the decedent owned a 97% interest in a closely held corporation which had as its primary asset 5,405 acres of timberland in Louisiana. The fair market value of the timber property was $6 million. Its tax basis was approximately $200,000. Citing *Davis*, the Court allowed a built-in capital gains discount. In discussing this opinion, Judge Gayle stated:

> We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built in capital gains over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built in capital gains in valuing decedent's Johnco stock.

77 T.C.M. at 1396.

The Court concluded that since capital gains taxes would be incurred as Johnco's timber was cut and sold, recognition of the gain was certain to occur independently of any liquidation that a hypothetical willing buyer of decedent's Johnco stock "would take into account Johnco's built in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However, the court limited the discount "an amount reflecting the rate at which they [the capital gains taxes] will be recognized, measured as the net present value of the built in capital gains tax liability that will be incurred over time as timber is cut." *Id.*

The Fifth Circuit Court of Appeals reversed the Tax Court's decision. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). The Court noted that the Tax Court had "deviated from several criteria of fair market value analysis, including assuming that a buyer was a strategic buyer who would continue to operate the corporation for timber production, peremptorily denying a full discount for the accrued capital gains liability based upon the erroneous assumption that the purchaser would engage in long range timber production." 267 F.3d at 371-72. The Court also noted that the Tax Court had internally inconsistent assumptions, assuming that a hypothetical purchaser of the stock would engage in long range timber production earning a 14% gross annual rate of return while requiring a 20% rate of return. Since the buyer would be earning less than his required rate of return, the buyer would either lower the purchase price or sell the interest quickly and redeploy the proceeds elsewhere. The Fifth Circuit remanded the case back to the Tax Court for valuation analysis consistent with its opinion.

In *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002), the Fifth Circuit applied a dollar-for-dollar discount for unrealized capital gains when determining the value of a 62.96% interest in a closely-held Texas corporation under an asset-based approach. At her death, Mrs. Dunn owned 62.96% of Dunn Equipment was family-owned and operated company in the business of renting heavy equipment to refinery and petrochemical businesses. Reversing the Tax Court, the Fifth Circuit held, as a matter of law, the $7.1 million built-in capital gains tax liability of Dunn Equipment's assets must be considered as a dollar-for-dollar reduction when calculating

the asset-based value of Dunn Equipment.[3] The Court opined that the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in capital gains tax. The holding makes rational sense, and should be applied in any asset-based valuation of a C corporation since the asset-based approach assumes that the buyer is paying for the stock of the entity based upon the price the buyer could realize for the assets of such entity. Before the buyer can realize such value, however, the corporate level capital gains tax must be incurred.

In *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), the Eleventh Circuit adopted the Fifth Circuit's dollar-for-dollar discount in *Dunn*.

In *Estate of Litchfield v. Comm'r*, T.C. Memo 2009-21 (January 29, 2009), the Court allowed an unrealized capital gain discount based upon the assumption that the assets would be sold over time. The estate's expert projected holding periods and estimated sales dates for the corporation's assets, anticipated appreciation to the sales dates, and discounted the capital gains back to the valuation date. The Court adopted this approach.

In *Estate of Jensen v. Comm'r*, T.C. Memo 2010-182 (August 10, 2010), the Court determined the unrealized capital gains tax discount to be applied when valuing an 82% interest in a C corporation holding appreciated assets. The principal assets of the corporation were real estate and improvements. The built-in capital gains tax would have been approximately $1.1 million if the assets had been sold on the date of the decedent's death. The Estate's expert determined that a dollar-for-dollar discount was appropriate because the "adjusted value method is based upon the inherent assumption that the assets will be liquidated, which automatically gives rise to a tax liability predicated upon the built-in capital gains that result from appreciation of the assets." This approach was similar to that used by the courts in *Estate of Dunn* and *Estate of Jelke*. However, because this case was appealable to the Second Circuit, the Court was unwilling to speculate as to whether or not the Second Circuit would apply a dollar-for-dollar unrealized capital gains discount as a matter of law and declined to adopt the expert's analysis.

The IRS's expert analogized the corporation to six closed end investment funds. He determined that the unrealized capital gains tax exposure did not exceed 41.5% of the net asset value for any of the six funds. He thus opined that a dollar-for-dollar discount should be applied only for that portion of the unrealized capital gains tax that exceeded 41.5% of the net asset value, but no discount to the extent that the unrealized capital gains tax did not exceed 41.5% of the net asset value. This resulted in a discount of approximately 50% of the built-in capital gains tax. The Court did not give much weight to Respondent's expert's valuation because it was not convinced that the closed end funds were comparable to the real estate owned by the corporation and because discounts for closed end funds are attributable to factors other than built-in capital gains.

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[3] It did not apply the same reduction when determining value under the income-based approach.

The Court used a present value approach to determine the built-in capital gains discount. The Court calculated the estimated future value of the land and improvements under two scenarios: (1) using a 5% appreciation rate (the rate of appreciation assumed in the taxpayer's real estate appraisal); and (2) using a 7.5% appreciation rate (based on pre-tax return of income data in the taxpayer's expert's report). It also assumed that the assets would be sold over a 17 year period, based upon the average useful life from the depreciation figures in the taxpayer's real estate report. The resulting tax amounts were discounted to present value using a discount rate equal to the assumed appreciation rate (although the Court did not discuss how the discount rate was determined). The Court's analysis resulted in unrealized capital gains tax with a present value of $1.23 million and $1.26 million under the two scenarios. Because these calculations exceeded the Estate's $1.13 million discount, the Estate's requested discount was allowed.

B. Undivided Interests in Real Estate

The IRS has often asserted that the only discount which should be applied when determining the fair market value of undivided interests in real property are the costs and expenses associated with a partition of that property. *See* PLR 9336002 (May 28, 1993). The Tax Court has consistently recognized, however, that IRS reliance on partition costs as the sole basis for the discount is misplaced.

In *Estate of van Loben Sels v. Comm'r*, 52 T.C.M. (CCH) 731 (1986), the Tax Court held that "a discount from the value determined by reference to the fee value is warranted because of the disabilities associated with decedent's undivided interest. The disabilities include lack of marketability, lack of management, lack of general control, lack of liquidity, and potential partitionment expenses." *Id.* at 742. The Court held that because of the disability associated with owning an undivided interest in the properties, "a minority discount of 60% is reasonable in this case." *Id.* at 743. *See also Estate of Forbes v. Comm'r*, 81 T.C.M. (CCH) 1399 (2001) (30% discount allowed for undivided 42% interest in 5,354 acres of real property); *Williams v. Comm'r*, 75 T.C.M. (CCH) 1758 (1998) (44% discount for undivided interest applied to a one-half undivided interest in approximately 4,600 acres of timber property in Florida); *LeFrak v. Comm'r*, 66 T.C.M. (CCH) 1297, 1308-10 (1993) (holding that a 20% minority interest and 10% lack of marketability discount applied for undivided interest in New York apartment and office buildings); *Estate of Baird v. Comm'r*, 82 T.C.M. (CCH) 666 (2001), holding that a 60% discount in valuing undivided interests in 16 non-contiguous tracts of Louisiana timber property.

In *Ludwick v. Comm'r*, T.C. Memo 2010-104 (May 10, 2010), the Tax Court determined the undivided interest discount for a 50 percent interest in a Hawaiian vacation home. In response to the Tax Court's question of why the discount should be any greater than the costs of partition, the experts for both the taxpayer and the IRS agreed that adjustments beyond the cost of partition should be allowed for lack of marketability and illiquidity risks because of the inability to sell the house quickly at fair market value. Essentially rejecting the opinions of both experts, the Court determined the discount under a present value approach assuming (1) a two year partition action would be required (resulting in a 26.5 percent discount) and (2) the property could be sold in

one year without a partition action (resulting in a 16.2 percent discount). The Court weighted those outcomes, concluding that there was a 90 percent likelihood that no partition action would be needed. This resulted in a discount of 17.2 percent. Given the Court's short holding period, the principal reason for the 17.2 percent discount was the existence of operating expenses of $350,000 per year. Had those operating expenses not been present, the discount would have been much lower. One factor that appears missing from the analysis is the general lack of marketability inherent in the interest. In other words, why would a buyer be interested in purchasing a property that they would simply turn around and sell in a partition action at a discount based on costs of partition and the time value of money?

C. Tiered Discounts

The IRS often takes the position that successive or tiered discounts should not be applied in determining the value of an interest in an entity which in turns owns an interest in another entity. But both the Tax Court and other courts have recognized the existence of "tiered discounts" when valuing an interest in a closely held entity. *See*, *e.g.*, *Astleford v. Comm'r*, T.C. Memo 2008-128 (May 5, 2008) (court applied discounts of 30% and 36% in valuing limited partnership interest in partnership that owned a general partnership interest in real estate venture); *Gow v. Comm'r*, 79 T.C.M. (CCH) 1680 (2000) (court applied combined discounts for lack of control and lack of marketability in valuing the stock of the top tier entity for 1989 and 1990, respectively, of 44% and 51%, and 41% in valuing the interest in the second tier entity); *Kosman v. Comm'r*, 71 T.C.M. (CCH) 2356 (1996); *Dean v. Comm'r*, 19 T.C.M. (CCH) 281 (1960); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

X. PRIVILEGES IN THE ESTATE PLANNING CONTEXT

Because of the recent IRS attacks on family limited partnerships and limited liability companies, IRS requests for documents at the audit level and in estate tax litigation increasingly include requests for communications with counsel and other persons involved in the estate planning process seeking to determine the motives for creating the entity. This is particularly true in the area of buy-sell agreements, family limited partnerships, and closely-held corporations, where the IRS has become more aggressive in seeking to have entities ignored for estate tax purposes on the grounds that the entity lacks "business purpose" or was created solely as a "device" to avoid estate taxes. Attached as Exhibit A is an example of the type of IRS document requests that have been served on taxpayers over the last several years in audits involving closely held entities. The requests are extremely intrusive and cover every aspect of the estate planning and entity administration process.

A. Preparation for the Transfer Tax Audit or Dispute Begins at the Estate Planning Level – Anticipate Your Potential Audience

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer's file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work

product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client's estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

Preparation for the transfer tax audit or dispute truly begins at the estate planning level. When writing letters or internal memoranda, think about how that document will look to an IRS agent, an appeals officer, or the ultimate finder of fact in tax litigation. Have you focused on all relevant reasons for the transaction or just the estate and gift tax savings that might be achieved through the transaction? Advise your client and the client's advisors, such as accountants or stockbrokers who are involved in the estate planning process, that their correspondence and their files may also be subject to production in a tax audit or in litigation.

B. Understand the IRS's Broad Subpoena Power

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer's representative, or a third party. For the purpose of "ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax," the IRS is authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. IRC § 7602(a).

Subject to any applicable privileges, the IRS can summon the taxpayer, the taxpayer's attorney, the taxpayer's accountants, and other third parties to produce books, papers, records, or other data and to testify on matters relevant or material to the IRS's inquiry. This summons power includes lawyers, accountants, and others involved in the planning process. It also includes doctors or other health care providers. The range of discoverable documents is also very broad and generally includes all documents in any form (including, for example, computer files and emails).

To enforce a summons, the IRS must show that the summons: (1) was issued for a legitimate purpose; (2) seeks information relevant to that purpose; (3) seeks information that is not already within the IRS' possession; and (4) satisfies all administrative steps required by the United States Code. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). However, the IRS's broad summons power remains subject to traditional privileges and limitations. *United States v. Euge*, 444 U.S. 707, 714 (1980). Thus, if the attorney-client privilege attaches to documents requested by the IRS, the IRS has no right to issue a summons to compel their production.

C. Understand and Preserve All Privileges

As noted above, the IRS's subpoena power is limited to nonprivileged material. Whether or not a privilege exists in the context of an IRS examination is a question of federal law. *Jaffee v. Redmond*, 518 U.S. 1 (1996); Fed. R. Evid. 501. There are three types of privileges that may apply to a lawyer's file and correspondence: (i) the attorney-client privilege; (ii) the attorney work product privilege; and (iii) the tax practitioner's privilege. With respect to medical records, the doctor-patient privilege and psychotherapist-patient privilege may also come into play. None of the privileges is as broad as most lawyers believe.

1. The Attorney-Client Privilege

a. What the Privilege Covers

The attorney-client privilege generally protects the disclosure of confidential communications between counsel and the client made for the purpose of facilitating the rendition of legal advice. The attorney-client privilege also protects "an attorney's advice in response to such disclosures." *In Re Grand Jury Investigation*, 974 F.2d 1068, 1070 (9th Cir. 1992). In addition, "[t]he attorney-client privilege applies to communications between lawyers and their clients when the lawyers act in a counseling and planning role, as well as when lawyers represent their clients in litigation." *United States v. Chen*, 99 F.3d 1495, 1501 (9th Cir. 1996). Communications with third parties, such as accountants or financial advisors, that are made to "assist the attorney in rendering advice to the client" are also generally protected. *See United States. v. Adlman*, 68 F.3d 1495, 1499 (2d Cir. 1995), *aff'g in part and vacating in part*, 1994 WL 191869 (May 16, 1994) ("[T]he privilege would extend to . . . an accountant hired by the attorney to assist the attorney in understanding the client's financial information.").

A privileged communication is "any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression." *See*, *e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass'n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) ("[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege."); *New York Underwriters Ins. Co. v. Union Constr. Co.*, 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney's billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir.

1982) (holding that bills, ledgers, statements, time records, and the like that reveal "the nature of the services provided" should be privileged).

The attorney-client privilege survives the death of the client. *Swidler & Berlin and James Hamilton v. United States*, 524 U.S. 399 (1998).

b. What the Privilege Does Not Cover

Communications with nonclients such as stock brokers, accountants, or other third parties that are *not* made to "assist the attorney in rendering advice to the client" are generally not privileged. *Adlman*, 68 F.3d at 1499. "What is vital to the privilege is that the communication be made *in confidence* for the purpose of obtaining *legal* advice *from the lawyer*. If what is sought is not legal advice but only accounting service . . . or the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Id.* at 1499-1500, citing *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Work papers of the attorney that do not constitute or contain communications from the client, drafts of documents, or correspondence with third parties do not fall within the attorney-client privilege. *See Hickman v. Taylor*, 329 U.S. 495, 508 (1947) (holding that the privilege did not attach to "memoranda, briefs, communications and other writings prepared by counsel for his own use in prosecuting his client's case; and it is equally unrelated to writings which reflect an attorney's mental impressions, conclusions, opinions or legal theories").

In addition, advice rendered in connection with tax return preparation has been held not to be privileged. *See United States v. Frederick*, 182 F.3d 496, 500 (1999). The *Frederick* Court's refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is "accountant's work," whether performed by an accountant or a lawyer. For lawyers who prepare tax returns for clients, *Frederick* is a must read case.

c. Waiver

Beware: even if a document is privileged, that privilege can be waived. Disclosing otherwise privileged communications between a lawyer and client to third parties may cause those communications to lose their privileged status. *See, e.g., United States v. Brown*, 478 F.2d 1038 (7th Cir. 1973).

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made "to assist the attorney in rendering advice to the client," are protected under the attorney-client privilege. *See, e.g.*, *Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney's direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) ("Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation."); *Black & Decker Corp. v.*

United States, 219 F.R.D. 87 (D. Md. 2003) (providing short form opinion did not constitute waiver of attorney work product privilege); *In re G-I Holdings Inc.*, 218 F.R.D. 428 (D. N.J. 2003) (privilege deemed waived by asserting reasonable cause defense on the basis of legal advice). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made "in confidence for the purpose of obtaining legal advice." *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir. 1973).

In a dispute we handled several years ago over whether the Service's summonses were enforceable in light of privilege issues, we argued that a holding of waiver in the context of communications to and from the client's financial advisors – where the communications were necessary for the purpose of rendering legal advice to the client in forming a business entity – would be contrary to the logic of the principle of the attorney-client privilege. *Segerstrom v. U.S.*, 87 A.F.T.R.2d 2001-1702, 2001 WL 263449 (N.D. Cal. 2001). The Court granted the taxpayer's request to quash the IRS's summonses, given the facts -- disclosure to third parties was shown to be necessary for the lawyer to render legal advice to the client.

2. The Attorney Work Product Privilege

Many lawyers believe that the attorney work product privilege absolutely protects their file from disclosure to third parties. The work product privilege is actually much narrower; it only shields from disclosure materials prepared "in anticipation of litigation" by a party or the party's representative, absent a showing of substantial need. Fed. R. Civ. P. 26(b)(3). The purpose of the doctrine is to establish a zone of privacy for strategic litigation planning and to prevent one party from piggybacking on the adversary's preparation. *See United States v. Nobles*, 422 U.S. 225, 238 (1975).

There is no bright line test to determine whether a document has been prepared "in anticipation of litigation." In the transaction planning process, however, it will be difficult to argue that an attorney's internal memos or work papers were prepared "in anticipation of subsequent litigation" with the IRS. *See United States v. Adlman*, 96-2 U.S.T.C. ¶ 50,493 (S.D.N.Y. 1996) (refusing to apply the work product privilege to an accountant's memorandum analyzing the "legal ramification of a proposed transaction to determine whether, despite a likely challenge, the legal risk was acceptable," and holding that "[t]he primary purpose of these documents was not to prepare for litigation; the primary purpose was to decide whether or not to go through with a multi-million dollar transaction"), *aff'd in part and rev'd in part,* 68 F.3d 1495 (2d Cir. 1995) (nothing that there is no bar to "application of work product protection to documents created prior to the event giving rise to litigation"), *supp. proceeding*, 134 F.3d 1194 (2d Cir. 1998) ("a document created because of anticipated litigation, which tends to reveal mental impressions, conclusions, opinions or theories concerning the litigation, does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation. Where a document was created because of anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation").

3. The Tax Practitioner's Privilege

In the Internal Revenue Restructuring Act of 1998, Congress added IRC § 7525, which extends the attorney-client privilege to confidential communications between taxpayers and practitioners that would protect the same "communication[s] between a taxpayer and an attorney." The privilege, however, is limited to (1) "non-criminal tax matters before the Internal Revenue Service" and (2) "non-criminal tax proceedings in Federal court brought by or against the United States." IRC § 7525. Because the work product doctrine is separate from the attorney-client privilege, the new privilege provision does not grant the work product privilege to non-attorney advisors.

Frederick was the first case to address the tax practitioner privilege. The *Frederick* court took IRC § 7525 into account in reaching its decision in concluding that, because the audit services rendered by the lawyer would not have qualified for the attorney-client privilege before enactment of the new privilege, the new privilege would not apply to the audit services rendered. *Frederick*, 182 F.3d at 502. Therefore, any information included in the documents involved in preparation of a tax return or involved in verification of a tax return during audit may lose either the attorney-client privilege or the new tax practitioner's privilege.

The First Circuit reinforced the *Frederick* court's construction of IRC § 7525 in *Cavallaro v. United States*, 284 F.3d 236 (1st Cir. 2002). In *Cavallaro*, the First Circuit upheld the granting of enforcement of summonses issued by the IRS given that information was disclosed to accountants in a merger deal, and the accountants were providing accounting services, not facilitating communication of legal advice. The First Circuit reasoned that an attorney does not render client communications to an accountant privileged merely by engaging the accountant.

The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*¸ 237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the Section 7525 privilege did not extend to KPMG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by Section 7525 were in fact so protected. *United States v. KPMG,* 2003-2 U.S.T.C. ¶50,691 (D. D.C. 2003). *See also United States v. BDO Seidman, LLP*¸ 225 F. Supp. 2d 918 (N.D. Il. 2003), *aff'd,* 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

4. The Physician-Patient Privilege

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce

a summons issued under federal statutory authority, federal privilege rules generally apply. *See, e.g., United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992). The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if It Is in the Client's Best Interest to Do So

The assertion of the privileges at the audit or Tax Court level lead to an inference that the taxpayer is hiding something. Arguing that a document should be shielded from discovery by an examining agent or district counsel because it is either subject to the attorney-client privilege or was prepared in anticipation of litigation may have evidentiary implications. *See, e.g., Estate of Shoemaker v. Comm'r*, 47 T.C.M. (CCH) 1462, 1464 n.7 (1984) ("Prior to trial, respondent sought discovery of estate planning files of Mr. Parsons' law firm pertaining to decedent. The attorney-client privilege was asserted and sustained by us, although we invited attention to the possibility that an unfavorable inference could be drawn from this assertion of the privilege.").

In cases where the IRS questions motives or business purpose, the best evidence can come from the correspondence prepared in connection with the transaction at issue. Well-drafted, contemporaneous correspondence outlining the business and financial reasons (*i.e.*, the nontax reasons) for the transaction being challenged, such as a buy-sell agreement or the creation of a family limited partnership or corporation, serve as wonderful evidence to rebut an argument from the IRS that an entity was created as "a device solely to avoid taxes" or lacks "business purpose." *See, e.g.*, *John J. Wells, Inc. v. Comm'r*, 47 T.C.M. (CCH) 1114, 1116 (1984). ("While obviously the true facts can never be known with complete certainty by an outsider. . . . We base our conclusion upon our view of the spoken testimony and how that testimony, coupled with the documentary evidence, comports with human experience.").

XI. WORKING WITH THE APPRAISER

A. Appraisals From Qualified and Respected Appraisers Should Be Obtained at the Appropriate Planning Stage

A great many of the challenges in the tax area focus on disputing a taxpayer's valuation with respect to hard-to-value assets such as partnership interests or closely held corporations. Assuming a supportable legal framework for a transaction with a hard-to-value asset, the only way for a taxpayer and the IRS to differ on the amount of the tax owed is for each to claim a different value for the asset transferred. If such a dispute arises and progresses to litigation, the result is determined after a "battle of the experts."

The taxpayer should not rely on anyone who does not have both the professional credentials and experience necessary to qualify as an appraiser to value a business interest. The taxpayer generally has the burden of presenting creditable evidence with proving the taxpayer's valuation position. T.C.R. 142(a); *Welch v. Helvering*, 290 U.S.

111, 115 (1933). The burden of proof in a court proceeding may shift to the IRS in certain cases where the taxpayer presents "credible evidence" with respect to the valuation issues. IRC ' 7491.[4] However, without a well-reasoned appraisal from a qualified appraiser, the taxpayer virtually has no basis to dispute what might prove to be an unrealistic valuation claim by the IRS. Likewise, the IRS has much less of an obligation to show proof of its valuation position. The appraiser should be reputable, qualified and independent. After all, the appraiser may be the taxpayer's expert witness in the event of an audit and any related litigation. If a qualified appraisal has not been obtained before filing the tax return, the taxpayer will have to pay for a second appraisal when the valuation dispute arises.

The existence of a well-reasoned appraisal from a qualified appraiser can in some cases prevent a valuation challenge from the IRS. When faced with the taxpayer's valuation based on the opinion of a well-respected, independent appraiser, the IRS is essentially forced to hire an equally qualified appraiser who can credibly attack the valuation opinion of the taxpayer's appraiser and can produce an opinion of value different enough to generate a tax revenue advantage for the IRS. The IRS is going to allocate resources to pay for appraisals if there is an expectation that allocation will be more than reimbursed. It is difficult for the IRS on a cost/benefit analysis to justify spending the money to challenge a reasonable appraisal from a qualified expert which is based upon widely used valuation techniques. This cost/benefit analysis can and should work to the advantage of taxpayers who utilize well-reasoned appraisals.

B. The Appraiser's Credentials and Credibility

One of the most important assets an appraiser can possess is credibility. The first job is to determine whether the appraiser is qualified to perform the task at hand. If you are not familiar with the appraiser's work, consider obtaining and reviewing copies of other appraisals that the appraiser has prepared. This will help you insure that the appraiser understands proper appraisal techniques and can present his or her opinions and conclusions in a concise, understandable form, and that the appraiser understands how to properly support his or her opinions.

Credentials are also an important factor. Does the appraiser have the appropriate level of experience and credentials to demonstrate his or her expertise in valuing the type of asset? For example, several professional organizations have programs for formal training and education of business appraisers. Examples include the American Society of Appraisers (ASA), the American Institute of Certified Public Accountants (AICPA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA). Likewise, real estate appraisers with an MAI designation

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[4] For the burden of proof to shift, the taxpayer must satisfy the following conditions: (i) the taxpayer must comply with the substantiation and record keeping requirements of the Internal Revenue Code and the regulations, (ii) the taxpayer must cooperate with reasonable requests by the IRS for witnesses, information, documents, meetings and interviews, and (iii) taxpayers other than individuals must have a net worth of less than $7 million.

are generally thought to be better credentialed than appraisers without such a designation. A designation, however, is not the be all and end all. Important consideration should be given to the appraiser's actual experience in valuing the type of asset being valued. For example, an MAI appraiser whose principal expertise is in valuing commercial real estate would not be as credible in valuing a large farm than a state certified appraiser with 20 years experience appraising properties in the county in which the farm being valued is located.

With the proliferation of appraisal firms, it is important to remember that you are hiring the individual appraiser, not the firm. The individual appraiser will ultimately be your expert witness to testify in support of the appraisal opinion, not the firm. When dealing with large appraisal firms or accounting firms who provide appraisal services, insure that you have satisfactorily established who your appraiser will be and who will be assisting the appraiser (if anyone) in the preparation of the appraisal report.

Before engaging the appraiser, it is also important to determine how the appraiser has been received by courts and if there are any published decision in which the appraiser was either criticized or adopted a methodology which might be inconsistent with issues presented in the fact situation. A legal database search under the appraiser's name or the appraiser's firm name can often turn up the answers to these questions. Likewise, determine whether the appraiser has published any books or articles which might be used to impeach the appraiser's work or, if you have employed more than one appraiser, your other appraiser's analysis.

Finally, the appraiser's role is to determine the fair market value of the property interest being appraised, giving consideration to all relevant facts, and to support that valuation with appropriate data and analysis. Although the appraiser must be confident in his or her methodology and conclusions, the appraiser should not become an advocate for the taxpayer's position. In other words, the appraiser cannot simply adopt the taxpayer's analysis or opinion of value, nor should the appraiser be seen as an "advocate." Once the finder of fact believes that the appraiser has become the taxpayer's "advocate" and not an independent expert engaged to apply appropriate appraisal techniques to determine the fair market value of the property interest being valued, the appraiser will lose credibility. As the Tax Court stated in *Martin Ice Cream Co.*, "experts are not supposed to be 'hired guns'; they lose their usefulness and credibility to the extent that they become mere advocates for the side that hired them." *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998), citing *Estate of Mueller v. Commissioner*, 63 T.C.M. (CCH) 3027 (1992) and *Estate of Halas v. Commissioner*, 94 T.C. 570 (1990). When credibility is lost, the appraiser's conclusions will no longer be considered helpful to the finder of fact in the valuation dispute, and they will be disregarded.

C. The Appraiser Must Apply the Appropriate Standard of Value

In preparing appraisals for tax purposes, many appraisers fail to focus on the correct definition of fair market value. For federal tax purposes, fair market value has long been defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell

and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b). "All relevant facts and elements of value as of the applicable valuation date shall be considered." *Id*. For purposes of determining the fair market value of property being valued, the identity and intentions of the recipient of the property is irrelevant. Frazier, "How Corporate-Level Capital Gains Taxes Affect Fair Market Value," ESTATE PLANNING, p. 200 (June 1996). "The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is not a personalized one which envisions a particular buyer and seller." *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297, 1299 (1993). *See also Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996) ("We are precluded from considering evidence submitted by the government regarding who actually received the assets."). This point has also been emphasized in the updated edition of VALUATION TRAINING FOR APPEALS OFFICERS (1998) (issued by the Internal Revenue Service National Office), which stresses the hypothetical willing buyer and seller, and states unequivocally that "it is irrelevant who are the real seller and buyer." However, if the interest being valued is a partial interest in property, the identity of the owner of the interests which are not being transferred and the effect of such ownership on the value of the property being transferred is highly relevant. *See* Treas. Reg. § 20.2031-1(b).

D. Dealing With Legal Issues

One of the more difficult areas in appraisal work is the question of how to deal with legal issues which are in dispute in the context of a valuation. Examples of such issues include the effectiveness of a buy/sell agreement and the rights of an owner of a partial interest in property. Examples of such partial interests include undivided interests in real estate, limited partnership interests, and ownership of less than all of the shares of a corporation. Each of these ownership interests carries with it a different bundle of rights and obligations under applicable state law.

Understanding the rights that a hypothetical seller can transfer, and the rights that a hypothetical buyer can receive, is critical to the valuation analysis. The appraiser's role is to determine the price at which property interest being valued would change hands between a willing buyer and a willing seller, both having reasonable knowledge of relevant facts. Relevant facts include all of the attributes attached to the property being transferred, including any legal rights or obligations attached to the property. For example, is the hypothetical buyer of a partnership interest automatically entitled to become a partner, or is the buyer limited to the status of a mere assignee (with no management rights, limited or no information rights and no right of withdrawal).

Most appraisers are unqualified to render a legal opinion, and should not try to do so. Where complex questions of law exist, the appraiser should rely on the opinion of qualified counsel as to the likely understanding of the rights and privileges attached with the interest being valued. For example, if a buy/sell agreement exists for a closely held entity and its application is uncertain, the appraiser generally should not opine on whether the buy/sell agreement is valid. A knowledgeable owner of the interest being valued – whether a buyer or seller – would likely consult with an attorney to analyze his or her rights in connection with the enforceability of such a buy/sell agreement, since the legal

issue may have a significant impact on the value of the property interest. *See*, *e.g.*, *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 231 (1990) ("a hypothetical willing buyer would have had the counsel of several advisors of formidable reputation"). It is not necessary to obtain a conclusive determination of the legal issue but, as the Tax Court stated in *Newhouse*, "it is a likely understanding of the rights and privileges . . . that will influence the terms of the sale, not whether we resolve this dispute over New York law."

E. Whether and When to Use a Team of Experts

In complex valuation assignments, the need for more than one expert often arises. The valuation of an undivided interest might include an analysis of local law regarding the rights of an undivided interest owner, an appraiser who can analyze both the 100% value of the property and the sales of comparable undivided interests. If the property is income-producing, a business appraiser might analyze the value on a "going concern basis." If environmental problems exist, an environmental engineer might be consulted to determine the cost of remediation or the effect of the problem on the property's fair market value. For a closely held business, experts such as business appraisers or investment bankers will be useful. If the business itself contains hard-to-value assets which require special expertise, those assets can be separately appraised by specialists.

Asset holding entities, such as family limited partnerships, will often require a multi-disciplined approach to value. Investments in such areas as real estate, mineral interests or agricultural properties usually require valuation by a specialist. By the same token, that same specialist cannot determine the value of an individual limited partnership interest unless he or she is also qualified as a business appraiser.

The 2010 amendments to FRCP 26(b) expanded work product protection to a number of categories of information in a testifying expert's file.[5] The parties are entitled to full discovery regarding each other's testifying experts, except for drafts of the expert report and most attorney-expert communications (unless undue hardship can be shown). FRCP 26(b)(4)(B), (C). Exceptions include communications related to (1) compensation, (2) facts or data provided by the attorney and used by the expert to form his opinions, and (3) assumptions provided by the attorney and used by the expert to form his opinions.

F. The Appraisal Should Be in a Form Which Fully Sets Forth the Appraiser's Conclusions and Is Admissible in Court

Even when an appraisal will only initially be used to establish the fair market values of an asset in connection with the filing of a tax return, the appraisal report should be in a form which will allow the report to be introduced in subsequent tax litigation. Preparation of the report with this potential end use in mind is not difficult and will avoid the need to have the appraiser prepare a new or revised report in the event the matter proceeds to trial. Rule 143(g) of the United States Tax Court sets forth the requirements for the expert's report, and provides:

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[5] A testifying expert is a testifying expert who has acquired facts or developed opinions in anticipation of litigation or for trial.

> The report shall set forth the qualifications of the expert witness and shall state the witness' opinion and the facts or data on which that opinion is based. The report shall set forth in detail the reasons for the conclusion, and it will be marked as an exhibit, identified by the witness, and received in evidence as the direct testimony of the expert witness, unless the Court determines that the witness is not qualified as an expert. Additional direct testimony with respect to the report may be allowed to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. . . . An expert witness's testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not unduly prejudice the opposing party, such as by significantly impairing the opposing party's ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness's testimony.

T.C.R. 143(g).

In most Tax Court cases, the appraisal report will serve as the expert's direct testimony. Unless permitted by the Court, no oral direct testimony from the appraiser will be admitted regarding the appraiser's valuation. It is, therefore, imperative that the appraisal contains all facts, data and reasoning on which the appraiser bases the valuation conclusion. The methodology must be rational and understandable. If a part of the appraisal is based upon third-party contacts, those contacts should be identified. If a part of the appraisal is based upon comparable sales or statistical data, the sales and statistical data should be identified and included in the report. While the inclusion of this material may make the report more cumbersome, it will allow the reader to fully understand all of the reasons for the appraiser's valuation conclusion. Put yourself in the position of the uninformed reader of the report who is attempting to use the appraisal to determine the fair market value of property – does the appraisal contain all of the information in a clear, rational and logical manner to allow the reader to fully understand and decide for himself whether the appraiser's conclusions are correct?

G. Avoiding Expert Disasters

Credential Inflation – The natural tendency of every expert is to look as impressive as possible. Unfortunately, this leads to the temptation of embellishing resumes and experience beyond the bounds of accurate reporting. This can and has lead to disastrous consequences on the stand when the opposition, after doing their homework, discovers and exploits any false claims thereby undermining the credibility of the witness. If you do not know your expert, make him provide evidence of any special claims to expertise besides normal credentials and education.

Prior Testimony or Articles – An expert is not necessarily bound forever to any statement made in a prior case or publication. However, if what he or she intends to say in your case is in conflict with prior testimony, you must be aware of it and there must be a reasonable explanation. The reasons are obvious. But the search for conflicting testimony does not end with an individual, in this day of large valuation firms you should also search out prior testimony or articles by anyone in that firm

The Uninformed Testifier – Some firms will staff a project in the following manner: the "number crunching" is done by young analysts; due diligence and report writing is done by middle level professions; a more senior project manager will review, edit reports and participate in some of the due diligence. Finally, the partner or other "top level" professional will review the report and, after being satisfied, will sign it. This many layers of involvement can be dangerous when the time comes for testimony. If the testifier did not attend meetings, due diligence sessions and is generally uninformed about the client's business, he or she may make a poor witness, regardless of impressive credentials.

Friendly Fire – When using more than one expert, make sure that both experts have read and discussed each other's reports after they have been filed. The experts should be kept apart while they are formulating their opinions so that the opposition can not claim collusion. But, after the reports are filed, they should be aware of each other's work. Failure to do so can allow your opposition to attempt to cause one expert to unintentionally impeach another one. For example, serious damage can be done by one expert simply agreeing to a leading and seemingly unimportant (from the vantage point of that expert) question which he has not really had time to consider.

XII. CHOICE OF FORUM IN A TRANSFER TAX DISPUTE

One of the most important decisions to be made when tax litigation becomes apparent is the choice of forum in which to litigate the dispute. The choice of forum can have a dramatic impact on a number of strategic issues, including whether the tax must be paid before suit is filed, the identity and tax experience of the finder of fact, the effect of legal precedent, the potential cost of litigation, the appellate venue, the identity of opposing counsel, and the possibility and effect of the IRS raising new matters. Three forums exist in which to pursue tax litigation. These forums are the United States Tax Court, the United States district courts, and the United States Court of Federal Claims.[6]

There are two types of litigation that the taxpayer can commence to determine the amount of a tax liability. The first type is "deficiency" litigation, which occurs in the Tax Court. In deficiency litigation, the IRS issues a statutory notice of deficiency identifying a proposed tax liability. The notice of deficiency serves as the jurisdictional prerequisite to proceed in the Tax Court,. The second type of litigation is "refund" litigation, which occurs in the United States district courts and in the United States Court of Federal Claims. Refund litigation is jurisdictionally premised on the payment of the full amount

[6] 26 U.S.C. § 7441, 7442; 28 U.S.C. § 1346(a)(1).

of the tax in dispute and the timely filing of a claim for refund with the IRS. Each of the three choices of forum for the transfer tax dispute has advantages and disadvantages.

A. Payment of the Tax?

The taxpayer does not have to pay the tax before proceeding in the Tax Court. Instead, the taxpayer has ninety days from date of the notice of deficiency to file a petition with the Tax Court in Washington, D.C. If the proposed deficiency is paid before the notice of deficiency is issued, the Tax Court will not have jurisdiction. If less than the entire proposed deficiency is paid before the notice of deficiency is issued, the notice of deficiency will be issued only for the balance of the deficiency.[7] However, payment of the proposed deficiency after issuance of the notice of deficiency but before (or after) the filing of the petition will not deprive the Tax Court of jurisdiction.[8]

To bring a case before the Claims Court or a Federal district court, the taxpayer must pay the entire deficiency and timely file a claim for refund with the IRS. Once the taxpayer files a refund claim, he may file a refund suit after six months if the IRS has not acted on the refund claim. If the IRS disallows the claim within six months, the taxpayer has two years from the date of the disallowance to file suit. The payment of the deficiency will stop the accrual of interest on the deficiency. If the taxpayer is successful in obtaining a refund, interest will be paid on the refund.

B. Finder of Fact

In the Claims Court and the Tax Court, the finder of fact is always the trial judge. In district court cases, either party has the right to request a jury trial. Tax Court judges have a background in tax law and only hear the tax cases. District court judges hear a broad range of diversity and federal question cases and typically do not have a background in tax law. Claims Court judges may or may not have a background in tax law. In each of these forums, the case is randomly assigned to the judge. If you have a case to which a jury might be sympathetic, a district court may be the better forum.

C. Legal Precedent

Before filing your case, determine whether the court or the court to where any appeal will be taken has unfavorable precedent. If, for example, the Claims Court has a case holding against your legal position but the Tax Court has a case holding in your favor, the Tax Court would likely be your forum of choice. An example of the importance of precedent in the transfer tax area is how a claim asserted against a decedent's estate is valued for estate tax deduction purposes. The Fifth Circuit has allowed a deduction based upon a "fair market value" of the claim as of the date of the decedent's death, and does not consider post-valuation date satisfaction of the claim.[9]

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[7] Rev. Proc. 63 11, 1963 1 C.B. 497.

[8] I.R.C. § 6213(b)(4).

[9] *See Estate of Smith v. Comm'r*, 198 F.3d 515 (5th Cir. 1999).

The Second Circuit, on the other hand, has only allowed the deduction only to the extent the claim was actually established and paid during estate administration.[10]

D. Discovery

Discovery is much more limited in the Tax Court.[11] Fact depositions are limited and experts are almost never deposed. Discovery in the Claims Court and district court is similar to traditional civil litigation. If the taxpayer is concerned about discovery costs, the Tax Court is generally the preferred forum.

E. Location of Trial

Tax Court cases are generally tried in the city designated by the taxpayer.[12] A list of cities in which regular sessions of the Tax Court are held is listed in the Tax Court Rules. If the taxpayer fails to designate a place of trial, the I.R.S. shall designate a place of trial preferred by the Commissioner.[13] Claims Court cases are often tried in Washington, D.C. District court cases must be filed and tried in the district where the taxpayer resides.

F. Appellate Venue

Another important consideration in choice of forum is the venue for any appeal. Tax Court cases and district court cases are appealable to the federal circuit court in which the taxpayer resides. Claims Court cases are appealable to the Federal Circuit Court of Appeals.

G. Opposing Counsel

Suits in the Tax Court are filed against the Commissioner of Internal Revenue. The Commissioner is usually represented by the IRS district counsel in the city in which the case is designated as the place of trial. Suits in the Claims Court and the district court are filed against the "United States of America." In Claims Court cases, the government is generally represented by Justice Department, Tax Division, Court of Federal Claims Section. In district court cases, the government is generally represented by Justice Department, Tax Division.

H. New Matters

In the Tax Court, the taxpayer has the burden of proof to show that the Commissioner's determination and adjustments were erroneous. Tax Court proceedings, however, toll the statute of limitations on the IRS's ability to assert an additional

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[10] *See Comm'r v. Shively*, 276 F.2d 372 (2nd Cir. 1960).

[11] *See* T.C.R. 70, 91.

[12] T.C.R. 140.

[13] *Id.*

deficiency. Accordingly, the IRS can raise a new matter in a Tax Court proceeding and seek an increased deficiency from the taxpayer. The burden of proof will be on the Internal Revenue Service with respect to the increased deficiency.[14]

In a refund suit, the burden of proof is on the taxpayer to show: (1) that the tax was overpaid; and (2) the amount of the overpayment. If the statute of limitations has expired on the taxpayer's return, new matters can be raised in the refund courts only as an offset to the amount of the refund sought. An additional deficiency cannot generally be sought if limitations have expired. Proceeding in the refund courts should be strongly considered where the taxpayer is concerned the IRS may raise issues not initially raised in the notice of deficiency.

XIII. WHERE ARE WE NOW AND WHERE ARE WE HEADED?

Court decisions have dealt a significant blow to the lack of economic substance, lack of business purpose, and gift on formation positions taken by the IRS in the family limited partnership area. Subject to the continuing development of case law and § 2036, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes. In fact, the § 2036 cases where the IRS has successfully disregarded the existence of an entity involve situations where the Tax Court has found that the partners have not respected and treated the partnership as a separate legal entity for state law purposes.

In light of these decisions, the IRS is primarily left arguing over the value of the partnership interest or, in cases where the entity has not been respected or where the decedent retained a significant amount of control, an argument that the entity should be ignored under IRC § 2036. In dealing with the IRS at the audit level and in litigation, I have seen the IRS increase its focus on the actual operations of the partnership. The IRS routinely requests the opportunity to examine the books and records of the partnership, the partnership's bank statements, and the documents conveying assets into the partnership. If distributions were made, were they made in accordance with the terms of the partnership agreement? Was the partnership operated as a separate legal entity, or merely a second bank account for the decedent? The IRS is inquiring, as did Judge Cohen in the *Strangi* opinion, whether the proverbial "i's are dotted and t's are crossed?" The IRS attacks on partnership based valuation discounts can be thwarted with careful planning, documentation and operation of the entity. This includes ensuring that the partners respect the entity and that qualified, supportable, and well reasoned appraisals are obtained when valuing the transferred interests.

Valuation discounts for lack of control and lack of marketability are real. A person acquiring an interest in a family limited partnership, particularly a non-controlling interest, lacks the ability to dictate how the partnership will be run and how distributions will be made. There is no established market on which the interest can be traded.

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[14] T.C. R. 142 (a); *Ferguson v. Comm'r*, 47 T.C. 11 (1966).

As can be seen from the table set forth below, taxpayers have sustained substantial valuation discounts in cases where the Court found their expert's valuation testimony more persuasive than the valuation testimony presented the Government. Practitioners must remember that the valuation report is the most important piece of evidence in a transfer tax dispute. Because the valuation filed with the transfer tax return constitutes an "admission" of value by the taxpayer, it is important for the taxpayer to obtain well-reasoned appraisals from a qualified appraiser ***when the return is filed***.

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	Dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Gallagher	publishing company	Tax	47%
Koons	cash	Tax	7.5%

LEGISLATIVE CHANGES?

- Rate/Unified Credit — Current 40% Gift/Estate Tax Rate and $5.2 Million Unified Credit
- Valuation Discounts — Proposal to Reduce Valuation Discounts on Closely Held Entities with Passive Assets/2704(b)?
- Grantor Trusts -- Proposal for Estate Tax Inclusion

Exhibit A

Internal Revenue Service Department of the Treasury

Date:

In Reply Refer to:

Person to Contact:

Contact Telephone Number:

Fax Number:

Re:

Dear

The United States Gift Tax Return you filed for the year _____ is being audited by this office. We need the information listed below furnished or made available for our inspection within the next three (3) weeks:

1. Copies of donor's Federal Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced above.

2. Copies of all 709's filed with with appraisals, acts of donation and other supporting documentation. This includes 709's filed by your spouse.

3. If any assets subject to any of the above referenced gifts have been sold or agreements to sell have been entered into subsequent to date of donation please provide complete details, including contracts, deeds and closing statements.

4. A list of donations of any kind, other than customay holiday and birthday gifts of small value, made during your life time regardless of whether a Gift Tax Return Form 709 was filed.

5. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:

a) All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
b) Articles of organization and operating agreement, with any amendments.
c) All documents that were prepared to meet state law requirements on the formation and operation of the entity.
d) All financial statements and tax returns prepared and/or filed since inception.
e) All of the entities' bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.

f) Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.

g) Evidence showing how the value of each entity asset was arrived at as of the date:
   1. it was contributed to the entity;
   2. of each gift of a interest in the entity;

provide all appraisals and supporting workpapers.

h) Evidence as to how the entity was valued as a whole as well as fractional interest. Provide all appraisals if not already furnished.

i) Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor.

j) For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, etc.).

k) For each entity asset, explain/provide:
   1. evidence that the entity owns the asset;
   2. when the donor acquired the asset;
   3. how the asset was used by the donor since its acquisition and how the entity has used the asset since; and
   4. who managed the asset prior to and after its contribution, explain in detail what management consisted of and how it changed after the entity was formed.

l) Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.

m) For each gift or transfer of an interest, provide:
   1. evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
   2. any assignment of any interest along with the terms of the assignment;
   3. the amount and source of any consideration paid along with an explanation as to how the amount was arrived at.

n) Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
   1. date of birth;
   2. education and occupation;
   3. experience and expertise in dealing with real estate, financial affairs and investments;
   4. extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof; and
   5. any personal financial statements and credit applications which were prepared in connection with loan applications after the LLC was created.

o) Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.
p) Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.
q) A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future requests for information, including a copy of the medical records, in necessary.
r) A copy of the Donor's will, revocable trust, and any executed power of attorney, if not submitted with the return.
s) A statement indicating the identity of the parties recommending the use of the LLC or partnership, when the recommendations were made, and the reasons set forth in support of using such an entity.
t) Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

Each item should be responded to either by furnishing the requested documentation; a written response, if called for, under the signature of the donor or a written explanation as to why the information will not be provided.

Should you have any questions call or write to me at he above number and address. A Form 2848 is enclosed for for your execution if you wish to appoint your attorney or CPA to represent you.

Very truly yours,

Enclosures:
IRS Publication 1
Form 2848 Power of Attorney