OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel (Passthroughs & Special Industries) CC:PSI

SUBJECT:

This Field Service Advice responds to your memorandum dated May 31, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
FLLC	=
Agreement	=
State	=
State Law	=
A	=
B	=
C	=
D	=
E	=
F	=
$a	=
$b	=
$c	=
$d	=
x%	=
y%	=
a%	=
b%	=
c%	=
d%	=
e%	=
f%	=

ISSUES

1. Does economic substance doctrine apply to this FLLC?

2. Does § 2703 apply to the valuation of an interest to this FLLC?

3 Can a restriction on liquidation of a family limited liability corporation (“FLLC”), which requires consent of x% the voting interests, be disregarded under I.R.C. § 2704(b)?

4. In the alternative, does a conversion of the transferred interests into assignee interests in the hands of the transferees trigger a transfer under I.R.C. § 2704(a)?

5. Does § 2036 apply to the assets decedent contributed to this FLLC?

6. Does the gift on formation argument apply to this FLLC?

7. In the alternative to all of the above, should the amount of the discount be challenged?

CONCLUSIONS

1. Maybe.

2. Maybe

3. Yes. The transferred interests should be valued as if the operating agreement provided that two-thirds in interest could compel liquidation.

4. Yes.

5. Maybe.

6. No.

7. Yes.

FACTS

D’s personal attorney, E, attended a seminar advocating use of family limited liability corporations. Later he advised D to form one. D engaged F to form FLLC.

D filed Articles of Incorporation with State on Date 1 for FLLC. Later, on Date 2, he and his three children, A, B, and C, executed Agreement that named A, B, C, and D as Members. The Agreement states that its effective date was Date 1 and provides that A, B, C, and D initially had respective membership interests of a%, b%, c%, and d%.

The Agreement provides, in part, that FLLC shall be dissolved on the earlier of: (1) Date 5, (2) the sale of substantially all of the company's property, or (3) the vote of members holding x percent of FLLC interests. No member has the right to demand a return of his capital contribution. The agreement may be modified only with the unanimous consent of the members. Under State Law, however, in the absence of a different percentage stated in the operating agreement, a limited liability company dissolves upon the vote of y percent interest of the members.

The Agreement also provides that FLLC shall dissolve upon the death of a member, unless a majority of the remaining members elects to continue the business of FLLC. In the event of an election to continue FLLC, the successor-in-interest of the deceased is deemed to be an assignee of the interest of the deceased member and may apply for admission to FLLC as a substituted member. Otherwise, the successor-in-interest may not exercise the voting rights of a member. Admission of an assignee as a substituted member is possible only after obtaining the consent of a majority of the interests held by the other members.

Finally, the Agreement provides that decisions require the consent of a majority of the managers. However, the power to invest, reinvest, sell, convey, mortgage, remortgage, or pledge all or any part of the company's property requires the consent of members holding a majority of the LLC interests.

On Date 3, D contributed $a worth of cash and marketable securities to FLLC. It is unclear whether D's children made any contributions to FLLC.

We understand you are clarifying this fact. In any event, shortly after Date 3, D made gifts of additional FLLC interests of e% each to A, B, and C. The following year, D again made gifts of FLLC interests of f% each to A, B, and C. By virtue of these transfers, D was left owning less than x% of the FLLC interests.

On Date 4, D died. Under D's will, his interest in FLLC passed in equal shares to A, B, and C. The will also names A, B, and C as executors of D's estate.

In Year 2, FLLC earned income in the amount of $b, in Year 3, $c, in Year 4, $d.

Gift tax returns were filed reporting the all of the interests in FLLC D gave to his children, including the initial provision of their interests in the Agreement . On the return reporting the Year 1 gifts, in valuing the transfers, D claimed a 30 percent discount from the net asset value of the property underlying the transferred FLLC interests. On the return reporting the Year 2 gifts, D's estate claimed a 44 percent discount. On the estate tax return, D's estate claimed a 41 percent discount. It is not clear what the bases of these claimed discounts were, although the materials in your incoming suggest that petitioner attributed them to minority interest discount, and marketability discount.

You are preparing to issue notices of deficiencies for gift taxes and estate taxes and you have requested our opinion on several potentially applicable arguments in support of those adjustments.

LAW AND ANALYSIS

Initially, we note that the transfers to the children on formation of FLLC were transfers of cash and securities, and not transfers of LLC interests On Date 3, D contributed $a worth of cash and marketable securities to FLLC. The agreement provides that no other capital contributions were required of the members, but that the children should each have an a% membership interest in FLLC. Thus, a portion of D's contribution was a contribution of cash and securities to FLLC on behalf of A, B, and C, in substance a transfer to A, B, and C, who then contributed the assets to FLLC in exchange for a membership interest. Cf. Estate of Stinson v. United States, 82 AFTR2d (RIA) 6944 (N.D. In. 1998), aff'd, 214 F.3d 846 (7th Cir. 2000).
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1. Background

Use of a family limited partnership, or its cousin, a family limited liability corporation, as a legitimate planning device has been recognized for several decades now. On the other hand, the potential for abusing these entities, i.e. use of these entities as mere devices to escape federal transfer taxes, has also long been recognized. Unfortunately, abuse of these entities has dramatically increased in the last several years. The abuse occurs when family assets are placed into a such an entity, ostensibly as capital contributions, solely for the purpose of reducing future estate or gift transfer taxes that will otherwise be attributable to those assets. After the assets have been thus "wrapped" in such an entity, and transferred to another family member, either by gift or inheritance, the taxpayer claims a substantial discount on the value of those assets, attributable to the form of the entity.

These discounts are usually claimed to be due to the lack of marketability of the interest, the minority nature of the interest, and/or other restrictions in the entity agreement.[1]
The courts have rendered several opinions on various aspects the subject. Those opinions are, necessarily, quite contingent upon the facts and circumstances, as well as the applicable state laws, of the underlying cases.

In Estate of Harrison, T.C. Memo. 1987-8, the Tax Court rejected our retained interest and lack-of-business-purpose arguments for reasons unique to the facts and posture of that case. But in Estate of Schauerhamer, T.C. Memo. 1997-242, the court agreed with the government's retained interest argument, under IRC § 2036. This argument, section 2036, again recently succeeded in Estate of Reichardt v. Commissioner, 114 T.C. No. 9 (March 1, 2000), where the court found that the discounts were not to be recognized because the decedent had continued to use of the property he had ostensibly contributed to the family limited partnership, which caused the property to be included in the estate.

An issue frequently arising is whether an interest transferred to another family member is a partnership interest or an assignee interest, the latter presumably being less valuable than the former. Several opinions have addressed it. In Estate of Nowell v. Commissioner, T.C. Memo. 1999-15, the Tax Court held that, under the relevant Arizona law, when a family limited partnership interest passed to an heir, absent a contrary provision in the partnership agreement, it was to be valued as an assignee interest, not a partnership interest. In Kerr v. Commissioner, 113 T.C. 449 (1999), the court held that under the unusual facts there, the transferred partnership interests remained partnership interests, not assignee interests. Quite recently, in Adams v. United States, 218 F 3d 383 (5th Cir. 2000), it had been stipulated that the transferred interest was an assignee interest. The lower court determined that since the assignee had a right to force a liquidation of the partnership, the claimed discounts were not available. The Fifth Circuit court reversed, holding that, under Texas law, an assignee's legal capacity to force a liquidation was very unclear. It remanded the case for a determination of the discount.

Another issue that has arisen is the applicability of § 2704 to the value of transferred interests, described in detail herein. Two cases have held that it was not applicable to the facts of those cases, in light of the relevant state laws, Kerr v. Commissioner, 113 T.C. 449 (1999) and Estate of Harper v. Commissioner, T.C. Memo. 2000-202. These cases are discussed below.

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[1] See Estate of Weinberg, T.C. Memo, 2000-51, for a recent example of the court's consideration and application of these discounts in the context of a non-abusive partnership.

Finally, in Estate of Church v. United States, 2000-1 USTC ¶ 60,369, Civil No. SA-97-CA-0774-OG (W. D. Tex. Jan 18, 2000), a district court ruled that the family limited partnership had been legally formed before the death of the decedent, even though the certificate of limited partnership had not been filed until several days after death, and the formation of the sole corporate general partner had not occurred until six months later. The government is currently appealing Church.

It can be seen that several of the arguments suggested below have yet to be ruled upon by any court, including our primary argument, lack of economic substance. All these arguments have been advanced at least once in three Tax Court cases that have been tried and are currently awaiting opinions. [redacted] Other cases that will raise those arguments may go to trial in the near future as well. We urge you carefully review the advice given here in light of any outcomes of those cases in the near future.

2. The economic substance doctrine

The primary argument to advance in cases such as these is that either the entity, be it a family limited partnership or family limited liability corporation (hereinafter referred to as the "family entity"), or the transaction by which a donor's assets are contributed to it, or both, lacked economic substance. If so, then discounts on the value of those assets, attributable to characteristics inherent only in a valid entity or transaction, are not allowed.

(a) Supreme court cases

It is clear that, for the purposes of federal taxation, the courts may completely disregard the form of an entity or a transaction if it is found to lack economic substance. This doctrine originates from the opinion of Gregory v. Helvering, 293 U.S. 465 (1935). There the Supreme Court held that an otherwise valid corporate formation and subsequent reorganization could be disregarded when the substance of those transactions was to avoid tax on a transfer of stock.

The Supreme Court later employed similar reasoning in disregarding the otherwise valid purchase of certain bonds and subsequent use of them as loan collateral, in Knetsch v. United States, 364 U.S. 361 (1960). There it found that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction," attributable to the alleged interest deductions. Knetsch, 364 U.S. at 366.

In other cases, the Supreme Court has employed this analysis with slightly differing verbal formulations. In U.S. v. Court Holding Co., 324 U.S. 331 (1945), it cited Gregory in disregarding a liquidating dividend, and said that the tax consequences of the transaction could not simply be determined by the means used to transfer title. Rather, "the transaction must be viewed as a whole and each step, from the commencement of the negotiations to the consummation of the sale, is relevant." Court Holding, 324 U.S. at 334. This formulation gave rise to the "step transaction" doctrine, which can be seen to be but a subset of the economic substance doctrine, see Commissioner v. Clark, 489 U.S. 726 (1989).

Similarly, in Commissioner v. Hansen, 360 U.S. 446 (1959), the Court used this same analysis to hold that the taxpayers had accrued income, and noted that "the incidence of taxation depends upon the substance, not the form of the transaction," Hansen, 360 U.S. at 461. The "substance over form" formulation is thus also seen as a derivative of the economic substance doctrine, see Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

(b) Circuit Court cases

This doctrine, in all its various forms, has enjoyed a healthy vitality in the circuit courts. In a wide variety of cases the courts have invoked it to disregard a diverse mix of transactions and entities, including loans, Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), purchases and sales of commodities, Kirchman v Commissioner, 862 F.2d 1486 (11th Cir. 1989) and DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988), partnerships, Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989) and Ferguson v. Commissioner, 29 F.3rd 98 (2d Cir. 1994), trusts, United States v. Noske, 117 F. 3d 1053 (8th Cir. 1997), and Zmuda v. Commissioner, 731 F. 2d 1417 (9th Cir. 1984), purchase and resale of corporate notes, ACM Partnership v. Commissioner, 157 F.3rd 231 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999); and the acquisition and exchange of ranch lands and oil and gas leases, True v. United States, 190 F.3d 1165 (10th Cir. 1999).

(c) Tax court cases

The Tax Court has invoked this doctrine too many times to count. It has recently used the doctrine to disregard: corporate owned life insurance (COLI) plans, Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), purchase and resale of American Depository Receipts (ADRs), Compaq Computer Corporation v. Commissioner, 113 T.C. 214 (1999), the contractual restructuring of excess valuation charges, United Parcel Service of America, Inc. v. Commissioner, T.C. Memo 1999-268, purchase and resale of corporate notes, Saba Partnership v. Commissioner, T.C. Memo. 1999-359, and trusts, George v. Commissioner, T.C. Memo. 1999-381, and Zachman v. Commissioner, T.C. Memo. 1999-391.

(d) Application of the rule

Since Gregory, it is therefore indisputable that the court must "look beyond the form of [the] transaction" to determine whether it has the "economic substance that [its] form represents," Kirchman, supra at 1490, because regardless of its form, a transaction that is "devoid of economic substance" must be disregarded for tax purposes. Lerman v. Commissioner, 939 F.2d 44, 45 (3rd Cir. 1991); accord, United States v. Wexler, 31 F.3d 117, 122 (3rd Cir. 1994).

The ACM opinion, supra, attempted to distill the holdings of prior economic substance cases into one coherent analysis:

> The inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them...[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes [emphasis added, citations omitted]

ACM, 157 F3d at 247.

The first of these two factors focuses on whether the transaction at issue had any practical economic consequences, other than the creation of tax benefits, i.e. whether the transaction appreciably changed the taxpayer's "economic position." Id. at 248-249. The second factor focuses on whether the taxpayer had a valid business purpose or profit motive. Id. at 253-254.[2]

The Tax Court cited this bifurcated analysis with approval, in both Winn-Dixie, supra, 113 T.C. at 280 and Saba Partnership, supra. In Compaq, supra, however, it only cited ACM generally, making no mention of ACM's particular analytical framework. Its analysis in Compaq nevertheless accords with ACM as it was grounded on findings that the transaction was predetermined, with controlled arrangements, and a lack of market risk (objective aspects), and that it lacked a business purpose (subjective aspect).

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[2] This analysis bears a striking resemblance to the "generic tax shelter" analysis once suggested by the Tax Court in Rose v. Commissioner, 88 T.C. 386, 408-415, aff'd on other grounds, 868 F2d 851 (6th Cir. 1989).

(e) Requisite level of business purpose

There are several other points about the law of economic substance that are pertinent. The first is that the ultimate question of whether the transaction or entity has sufficient economic substance for tax purposes is a factual one, United States v . Cumberland Pub. Serv. Co, 338 U.S. 451, 456 (1950); ACM, supra, 157 F. 3d at 245. On the other hand, there are some indications that certain aspects of that question have legal import.

Recent cases imply that the mere presence of some business purpose, or some actual economic effect, does not necessarily rebut the argument that a given overall transaction lacks economic substance. The Tenth Circuit has observed:

> We acknowledge the Trues' evidence of business purpose and economic effects. However, we do not agree with their conclusion that business purposes and economic effects relating to the individual steps in each complex series of transactions preclude application of the step transaction doctrine in this instance. The substance over form inquiry is not nearly as narrow as the Trues suggest. To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle. Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transnational steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. U.S., supra, 190 F.3d at 1176-77.

Similarly, the Tax Court recently found that a trust lacked economic substance despite the fact the petitioners claimed that its purpose was to protect family assets, in that case a farm, Zachman v. Commissioner, supra. The court did not appear to find that such was not their purpose, as a factual matter, but rather that it was not their primary purpose:

> We conclude that any such objective [to protect the farm property] was peripheral to petitioners primary objective of deflecting their taxable income.

Zachman, supra. See also George v. Commissioner, supra (trust lacked economic substance).

These cases imply that to show lack of economic substance, it is sufficient to show that tax savings was the primary purpose, not the sole purpose. The courts will not be confused by the presence of peripheral incidents that are imbued with economic substance.

(f) The economic substance doctrine applies to the validity of partnerships.

The second point to emphasize is that the courts have had no reluctance to find that a partnership itself lacks economic substance. In a recent Fifth Circuit opinion, the court agreed that a partnership, ostensibly engaged in the actual operation of an oil rig, nevertheless lacked economic substance and could be disregarded. Merryman v. Commissioner, supra. Once the partnership was disregarded, various tax benefits of the partnership, including losses and credits were disallowed.

Some of the factors relied upon by Merryman included (1) a pattern of "interconnected ownership of the partnership and related entities," (2) a failure of all the partners to contribute capital, (3) a lack of arms length transactions, and (4) lack of evidence of partnership business activity. Merryman, supra at 883.

(g) The economic substance doctrine is not limited to income tax cases.

Although the cases cited so far have all been income tax cases, the economic substance doctrine is not so limited. In Estate of Murphy v Commissioner, T.C. Memo. 1990-472, the court disregarded, for estate and gift tax purposes, an otherwise legitimate transfer of property, because it found that the substance of the transaction was to generate a minority discount for transfer tax purposes.

Although the facts in Estate of Murphy involve closely held stock, not a partnership, the case is still very relevant here because the court specifically applied the substance-over-form doctrine to disregard an otherwise valid transaction. The transaction at issue there was Mrs. Murphy's transfer, just before her death, of just enough of her closely held stock to her children so as to reduce the size of the remainder of her stock to an amount slightly less than 50 percent of the total outstanding stock. Thus, her estate claimed a minority discount for the stock she retained at her death.

Although the Estate of Murphy opinion preceded the ACM analysis, its reasoning closely parallels ACM. The court focused on the decedent's subjective intention (to obtain a minority discount) and the objective economic facts (she nevertheless retained effective control of the closely held corporation). It specifically cited the rationale of Gregory v. Helvering, supra, and Knetsch v. United States, supra, and held:

> The same rationale applies in the cases before us. Here, we conclude that decedent's two small lifetime gifts of [the closely held stock] do not appreciably affect decedent's beneficial interest except to reduce Federal transfer taxes.

Estate of Murphy, T.C. Memo. 1990-472.

Moreover, at least three circuit courts and one federal district court have expressly or implicitly held that the economic substance doctrine applies to gift tax cases, involving intra-family transactions. See, Heyen v. United States, 945 F.2d 359, 363 (10th Cir. 1991); see also Schultz v. United States, 493 F.2d 1225, 1226 (4th Cir. 1974); Vose v. Commissioner, 284 F.2d 65, 68-69 (1st Cir. 1960); Griffin v. United States, 42 F. Supp.2d 700 (W.D. Tex. 1998).

In the instant case, for reasons similar to those in Estate of Murphy, the transaction to be disregarded is the creation of FLLC and its use as a "wrap" of the taxpayer's' assets placed in FLLC. As in Estate of Murphy, the transaction did not appreciably affect his beneficial interest except to reduce Federal transfer taxes.

(h) Partnerships must have a valid business purpose for purposes of federal taxation.

There is a completely separate line of cases, amounting to another doctrine, that essentially compels the same result in any case where a partnership lacks a business purpose. These are the progeny of Commissioner v. Tower, 327 U.S. 280 (1946). See e.g. Vanderschraaf, et al. v. Commissioner, T.C. Memo. 1997-306, and the cases cited therein, and ASA Investerings v. Commissioner, T.C. Memo. 1998-305.

In Tower, the court held that state partnership laws do not control whether a partnership will be recognized for federal tax purposes. The issue there was the validity of a limited partnership formed by a husband and wife that complied with

Michigan state law. The court famously defined a partnership for federal tax purposes as occurring when:

> persons join together their money, goods, labor, or skill <u>for the purpose of carrying on a trade, profession or business</u> and when there is a community of interest in the profits and losses. The partners' intention to join together for the purpose of carrying on business and sharing in the profits or losses is a question of fact. (emphasis added)

<u>Id.</u> 327 U.S. at 286.

In the <u>Tower</u> case, the Supreme Court found the dispositive facts to be that the taxpayer husband continued to manage, control and run the business and that he continued to have funds at his disposal to use in the business or to expend for family expenses. The taxpayer wife did not contribute her services and took no part in the management or operation of the business. Because of these facts, the Supreme Court in <u>Tower</u> sustained the Tax Court's determination that the partnership brought no real change in the economic relation of the husband and wife to the income in question.

The Supreme Court revisited the question in the case of <u>Commissioner v. Culbertson</u>, 337 U.S. 733 (1949). Again confronted with a family partnership, the Court refined certain points of its analysis, but still retained the point being urged here.

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the <u>Tower</u> case, but whether, considering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent--the parties <u>in good faith and acting with a business purpose</u> intended to join together in the present conduct of the enterprise. " (emphasis added)

<u>Id.</u>, 337 U.S. at 742.

<u>(i) Intra-family transactions are closely scrutinized.</u>

One final, well-established, legal doctrine is pertinent in consideration of FLLC. That is the principle that intra-family transactions are to be closely scrutinized. The origin of this doctrine appears to be Helvering v. Clifford, 309 U.S. 331, 335 (1940) (husband trustee of trust for the benefit of wife shown to have constructively received income from the trust), see Commissioner v. Tower, supra, 327 U.S. 280, 291.

The rationale for this doctrine is that intra-family transactions prompt special scrutiny by the courts because the genuineness of the transactions cannot reasonably be inferred from any circumstantial assurances of a business purpose. Estate of Huntington v. Commissioner, 16 F.3d 462 (1st Cir. 1994); Kincaid v. United States, 682 F.2d 1220, 1225 (5th Cir. 1982).

(j) Conclusion

The foregoing shows that the doctrine of economic substance is applicable to family limited partnerships and family limited liability corporations, and to transfers of assets to them, if it can be shown that the primary purpose for the transaction was to reduce federal transfer taxes.

3. Applicability of § 2703

Section 2703(a)(2) provides, in part, that, for purposes of the estate, gift and generation-skipping transfer tax, the value of any property shall be determined without regard "to any restriction on the right to sell or use such property."

Section 2703(b) provides that § 2703(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 arms' length transaction.

Treas. Reg. § 25.2703-1(a)(1) provides, in part, that the value of any property is determined without regard to any right or restriction relating to the property. Section 25.2703-1(a)(2) provides that the terms right or restriction include "any" restriction on the right to sell or use the property. Section 25.2703-1(a)(3) provides that a right or restriction may be contained in a partnership agreement. A right or restriction may be implicit in the capital structure of an entity.

Treas. Reg. § 25.2703-1(b)(2) provides that each of the three requirements of section 2703(b) must be independently satisfied for a "right or restriction" to be exempt from the application of section 2703(a).

Under section 2703(a)(2), the value of "property" transferred is determined without regard to any restriction relating to the "property". In the instant case, the "property" subject to D's transfers was the underlying FLLC assets. Further, applied within the context of section 2703(a)(2), which focuses on restrictions on the right to sell or use property, we believe that a "device" under section 2703(b)(2) is reasonably viewed as including any restriction that has the effect of artificially reducing the value of the transferred interest for transfer tax purposes without ultimately reducing the value of the interest in the hands of the transferee-family member. Under these circumstances, the FLLC agreement satisfies this description.

The factual record required to support the economic substance analysis discussed above may also support the application of section 2703(a)(2) and its exceptions, to disregard the management agreement in determining the value of both the inter vivos and testamentary transfers.

Finally, even if the FLLC interests are recognized as the subject matter of the transfers, section 2703(a)(2) would still apply. As discussed above, under section 2703(a)(2), the value of any property is determined without regard "to any restriction on the right to sell or use such property." Further, under Treas. Reg. § 25.2703-1(a)(3), the restriction is subject to section 2703 whether arising under the terms of the partnership agreement or "implicit in the capital structure of an entity." See also, Informal Senate Report on S. 3209, 136 Cong. Rec. S. 15679, S.15683 (Oct. 18, 1990) ("The bill provides that the value of property for transfer tax purposes is determined without regard to . . . any restriction on the right to sell or use such property . . . These requirements apply to any restriction, however created.")

The FLLC agreement and state law impose several impediments on a transferee's ability to sell or use the property that would normally be taken into account in determining fair market value. For example, a member may not withdraw or transfer his interest absent the written consent of a majority of the other members, the giving of which is entirely discretionary. The transferee must adopt all the provisions of the management agreement and pay all reasonable expenses related to admission. An inter vivos transfer in contravention of the agreement is void, and a testamentary transferee takes only an "assignee" interest. As an assignee, the transferee may share in profits and distributions, but otherwise, has no liquidation rights unless FLLC terminates. Further, under the agreement, a member may not unilaterally withdraw or reduce his capital contribution. Dissolution can only occur with the consent of x% of the members, on termination of FLLC, on the death of a member (unless the remaining members elect to continue FLLC), on the sale of substantially all of FLLC's assets, or on the entry of a decree of judicial dissolution pursuant to state law.

These restrictions constitute restrictions on the member's right to use the FLLC interest and impede the member's ability to sell an interest. Accordingly, these restrictions are disregarded under section 2703(a)(2) in valuing the FLLC interest.

<u>4. A restriction on liquidation requiring consent of x% the voting interests can be disregarded under § 2704(b).</u>

To the extent that portions of the claimed discounts are attributable to the Agreement's restrictions on liquidation, you are correct in suggesting that § 2704 may invalidate those discounts.

The Code provides that if someone transfers a partnership interest to a member of the transferor's family, and after the transfer the transferor's family has control of the partnership, then, for the purposes of valuing the transferred interest, certain "applicable restrictions" can be disregarded. § 2704(b)(1). The term "applicable restriction" means any restriction which effectively limits the ability of the partnership to liquidate, and which is removable, in whole or in part, by the transferor or any member of the transferor's family. § 2704(b)(2).

The regulations further define "applicable restriction." To be disregarded, the limitation on liquidation at issue must be "more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction." Treas. Reg. § 25.2704-2(b). They also illustrate the statute's intended effect. If an applicable restriction is disregarded, then the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under the state law that would apply but for the restrictions. Treas. Reg. § 25.2704-2(c).

The regulations also illustrate these principles with several examples. Treas. Reg. § 25.2704-2(d)(Example 1) provides that D owns a 76 percent interest and each of D's children, A and B, owns a 12 percent interest in General Partnership X. The partnership agreement requires the consent of all the partners to liquidate the partnership. Under the State law that would apply in the absence of the restriction in the partnership agreement, the consent of partners owning 70 percent of the total partnership interests would be required to liquidate X. On D's death, D's partnership interest passes to D's child, C. The requirement that all the partners consent to liquidation is an applicable restriction. Because A, B and C (all members of D's family), acting together after the transfer, can remove the restriction on liquidation, D's interest is valued without regard to the restriction; *i.e.*, as though D's interest is sufficient to liquidate the partnership.

Treas. Reg. § 25.2704-3 provides that section 25.2704-2 applies to transfers occurring after January 28, 1992, of property subject to applicable restrictions created after October 8, 1990.

Each of the conditions of section 2704(b)(1) is satisfied in this case. First, the inter vivos transfers and the testamentary transfer were either interests in a partnership or a corporation, because a limited liability corporation with two or more members, such as FLLC, must be one or the other. See Treas. Reg. § 301.7701-3(a).[3] Second, The transfers were to members of the transferor's family because A, B, and C, as D's children, were lineal descendants of the transferor. See § 2704(c)(2)(B). Third, the transferor and members of the transferor's family held, immediately before the transfer, control of the entity. For purposes of section 2704, "control" has the meaning given such term by § 2701(b)(2). § 2704(c)(1). Section 2701(b)(2)(B) provides that, in the case of a partnership, the term "control" means either the holding of at least 50% of the capital or profits interests in the partnership or, in the case of a limited partnership, the holding of any interest as a general partner. Since, combined, A, B, C, and D held 100% of the capital and profits interest in FLLC immediately before the transfer, the transferor and members of the transferor's family held control of the entity at that time. Fourth, the provision of the operating agreement requiring the vote of x% of the members prior to dissolution is more restrictive than State Law, which requires only y% interest. Further, the transferor and members of the transferor's family (i.e., A, B, C, and D) collectively, by virtue of owning 100% of the membership interests, had the right after each transfer to amend the Agreement to remove the restriction. Accordingly, the restriction is an "applicable restriction" within the meaning of section 2704(b)(2). Treas. Reg. § 25.2704-2(d)
(Example 1).

The opinions of the Tax Court in Kerr v. Commissioner, 113 T.C. 449 (1999) and Estate of Harper v. Commissioner, T.C. Memo. 2000-202, do not suggest a contrary result. In those cases the Commissioner argued that a provision limiting the right of a partner to withdraw that was more restrictive than the default provision of state law was an applicable restriction within the meaning of section 2704. The court held that an applicable restriction is one limiting the ability of the entire entity to liquidate, and not one simply limiting the liquidation of the individual interests. Here, the restriction on liquidation relates to the liquidation of the entire entity.

In the context of valuing transfers of minority interests, however, disregarding the terms of the operating agreement in favor of a state law requiring only the vote of

[3] Your incoming does not state whether FLLC filed a Form 8832. If not, as is assumed herein, then the entity is a partnership. See Treas. Reg. 301.7701-3(b)(1) and (c).

y% interest may not result in a significant difference in value. Regardless of whether y% interest or x% of the interest is required to liquidate, the holder of a minority interest cannot alone compel liquidation. But the application of § 2704(b) to the transfer of a majority interest probably produces a much more significant result. If the applicable restriction is disregarded in favor of the State Law default provision, the holder could join one of the minority holders and together they could dissolve FLLC. Upon dissolution, FLLC would liquidate and distribute to its members the cash remaining after its assets were sold and debts paid. Thus the application of § 2704 may have a greater utility in the estate tax evaluation of D's interest than in the gift tax evaluations of D's gifts to his children. The exact value of the interests after the application of § 2704 of course is a question of fact to be determined by a competent expert, applying generally accepted valuation principles.

D's estate may argue that upon transfer, under the Agreement, the transferred interests become assignee interests, as opposed to FLLC membership interests. Assignees have no liquidation rights under either the Agreement or under local law. As the restrictions on an assignee's liquidation rights do not differ under the agreement from those imposed by local law, there is no applicable restriction to be disregarded under section 2704(b).

Assuming arguendo that the estate is correct, and that the transferred interests become assignee interests, under section 2704(b) the interest to be considered is the LLC interest. Congress enacted section 2704, among other provisions, in response to number of tax motivated transactions which had been used to reduce value for transfer tax purposes while not reducing the value ultimately received by the transferee. Informal Senate Report on S. 3209, 101st Cong., 2d Sess. (1990), 136 Cong. Rec. S15679-S15682 (October 18, 1990), reprinted in Tax Mgmt. (BNA) § 2701, pp. 147, 153-158 (2/20/91). The legislative history provides:

> Present Law
>
> . . .
>
> Lapsing Rights
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> Some courts have held that the fair market value of property is determined the moment after death. Under this theory, the value of a right that lapses upon death is not subject to estate tax.
>
> . . .
>
> Conference Agreement
>
> . . .
>
> Treatment of Certain Restrictions and Lapsing Rights

In General

The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306 (1987). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

Lapsing Rights

The conference agreement provides that the lapse of a voting or liquidation right in a family controlled corporation or partnership results in a transfer by gift or an inclusion in the gross estate. The amount of the transfer is the value of all interests in the entity held by the transferor immediately before the lapse (assuming that the right was nonlapsing) over the value of the interests immediately after the lapse. The conference agreement grants the Secretary of the Treasury regulatory authority to apply these rules to rights similar to voting and liquidation rights.

> Example 6 Parent and child control a corporation. Parent's stock has a voting right that lapses on Parent's death. Under the conference agreement, Parent's stock is valued for federal estate tax purposes as if the voting right of the parent's stock were nonlapsing.
>
> Example 7 Father and Child each own general and limited interests in a partnership. The general partnership interest carries with it the right to liquidate the partnership; the limited partnership interest has no such right. The liquidation right associated with the general partnership interest lapses after ten years. Under the

> conference agreement, there is a gift at the time of the lapse equal to the excess of 1) the value of Father's partnership interests determined as if he held the right to liquidate over 2) the value of such interests determined as if he did not hold such interests.
>
> Restrictions
>
> Under the conference agreement, any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored in valuing a transfer among family members if (1) the transferor and family members control the corporation or partnership, and (2) the restriction . . .can be removed by the transferor or members of his family, either alone or collectively.
>
> Example 8. Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. Under the conference agreement, the value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.
>
> This rule does not apply to a commercially reasonable restriction which arises as part of a financing with an unrelated party or a restriction required under State or Federal law. The provision also grants to the Treasury Secretary regulatory authority to disregard other restrictions which reduce the value of the transferred interest for transfer tax purposes but which do not ultimately reduce the value of the interest to the transferee.

H. R. Conf. Rep. No. 964, 101st Cong., 2nd Sess. 1130-38 (October 27, 1990), <u>reprinted in</u> 1990 U.S. Code Cong. & Admin. News 2017, 2842-43.

Section 2704(b) by its terms applies to the transfer of a partnership interest in the intra-family context. However, if the assignee status of the LLC interest is the only status taken into account, the statute would have no application to the transfer of partnership interests. The legislative history and the regulations make it clear that assignee status is not taken into account in applying the statute.

In Example 8 of the conference report, Mother and Son are partners in a two person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and bequeaths her partnership interest to daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. The example concludes that the value of Mother's partnership interest is determined without regard to the restriction on termination. If, as the estate may claim, section 2704(b) does not apply to an assignee interest, Example 8 would be meaningless. The interest passing from Mother to Daughter is an assignee interest. The example, however, ignores the assignee status of the interest and applies section 2704(b).

Similarly, Treas. Reg. § 25.2704-2(d)(Example 1), quoted above, applies section 2704(b) by ignoring the fact that D's general partnership interest first passed to D's estate (possibly as an assignee interest) and then to D's child, C (also possibly as an assignee interest before C was admitted as a general partner). Rather, the example applies section 2704(b) as if a partnership interest were transferred directly from D to C. The example disregards any assignee status with respect to D's interest. Under section 2704(b)(4), which grants the Secretary broad authority to promulgate regulations under section 2704(b), the regulations should carry significant weight.

The legislative history and the regulations do not take the assignee status into account because in the family context to which the statute is directed, this status is largely transitory. In the intra-family context the interest a transferee receives is an assignee interest that carries with it the full potential for substitution as a partnership interest with the rest of the family and therefore is treated as a partnership interest for purposes of section 2704(b). Under these circumstances, substitution as a partner is a foregone conclusion, and the interest transferred is viewed as a full partnership interest for purposes of section 2704(b). Cf. Kerr v. Commissioner, 113 T.C. 449, 463-68 (1999)(applying an economic substance analysis in disregarding assignee status); cf. Estate of Nowell v. Commissioner, T.C. Memo. 1999-15.

Even if substitution as a full member were not automatic, it would seem that, given the provisions and restrictions in the subject operating agreement (e.g., limiting an individual member's ability to liquidate the entity and vesting management in a majority of the members) and the investment nature of LLC's activities, there would be no valid reason for the remaining members to withhold consent. Absent a showing to the contrary, it would appear extremely unlikely that the assignee would not be admitted as a full member.

Section 2704 must be read in light of the problem Congress was attempting to resolve, that of lapsing rights in family entities which transfer value, and restrictions in family entities that reduce value, but which were not recognized for transfer tax purposes, with the result that substantial economic transfers were not subjected to transfer tax. Before the enactment of section 2704, the court had held in Estate of Harrison[4] that the partnership interest there was to be valued after the lapse of the transferor's liquidation right, with the result that a substantial portion of the value of the property was never subjected to transfer tax despite the fact that the transferor's family effectively received the full value of the transferred property.

In section 2704, Congress altered the Harrison analysis by mandating a before and after inquiry to determine whether the lapse or restriction is one within the intendment of the statute, and if so, to determine the amount of the transfer.

Section 2704(a)(1) provides, in part, that if there is a lapse of any voting or liquidation right in a partnership, and the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, such lapse is treated as a taxable transfer. The amount of the transfer is the value of all interests held before the lapse less the value of such interests immediately after the lapse. Stated another way, in the case of a lapse, if the family holds control both before and after the lapse, the transfer is the difference in the value of the property before and after the lapse.

Section 2704(b)(1) provides, in part, that in the case of a transfer of an interest in a partnership to a member of the transferor's family, if the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, then an applicable restriction will be disregarded in valuing the transferred interest. An applicable restriction is one which limits the ability of the partnership to liquidate, but which the transferor or the family, either alone or collectively, has the right to remove after the transfer. Stated another way, in the case of a transfer subject to a restriction, if the family holds control both before and after the transfer, the transfer is valued without regard to the restriction.

The assignee argument ignores the mechanics of the section 2704(b) statutory scheme. Section 2704(b) contemplates that where an interest is a partnership interest in the hands of the transferor, the term "interest in a partnership" as used in

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[4] See also Estate of Watts v. Commissioner, 823 F. 2d 483 (11^{th} Cir. 1987) (the partnership interest to be valued is that which decedent transferred at death, not the interest held by decedent before death, or that held by devisee after death.)

that section means the partnership interest. In order to determine whether section 2704(b) applies at all, section 2704(b)(1) applies a two part test. First, there must be a "transfer of an interest in a . . . partnership". Second, the transferor and members of the transferor's family must "hold, immediately before the transfer, control of the entity." I.R.C. § 2704(b)(1).

Congress used the term "transfer" to identify both the property subject to section 2704(b) — "transfer of an interest in a partnership" — and the time to apply the control test — "immediately before the transfer." Use of the same term in both parts of a two part test suggests that Congress attached the same meaning in both tests. On the other hand, the assignee argument requires that the tests be applied at two different times. In essence, the argument is that the "interest in a partnership" be determined <u>after</u> the transfer, while the control test be applied <u>before</u> the transfer. Under this interpretation, then, a test contained within a single integrated statutory provision requires two different times just to determine the threshold application of the statute[5]. The only logical inference here is that Congress intended that the threshold test of section 2704(b)(1) be applied immediately before the transfer, at a time the interest was a partnership interest.

The assignee argument also ignores the purpose of the section 2704(b). The problem Congress was attempting to resolve was that of illusory restrictions in family entities that reduce the value of the transferred interest for transfer tax purposes but which did not ultimately reduce the value of that interest to the transferee. Before the enactment of section 2704, the courts had held that value was to be determined at a single moment in time, immediately after the transfer, with the result that substantial value was never subjected to transfer tax. In section 2704, Congress altered that analysis by mandating a before and after inquiry that begins before the transfer. In the context of lapsing rights the inquiry begins with the determination of the value of all interests held by the transferor immediately before the lapse. In the context of restrictions on liquidation, the inquiry begins with the determination of whether the family has control of the entity (and thus can remove the restriction) immediately before the transfer.

The assignee argument is likewise inconsistent with the legislative history. Congress was certainly aware of the general rule that, in the context of partnership

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[5]Congress clearly knew how to say that a test was to be applied after the transfer, and indeed it did so in describing an applicable restriction. An applicable restriction is one which effectively limits the ability of the partnership to liquidate with respect to which either (i) “the restriction lapses, in whole or in part, <u>after</u> the transfer described in paragraph (1),” or (ii) “the transferor or any member of the transferor’s family, either alone or collectively, has the right <u>after</u> such transfer to remove, in whole or in part, the restriction.” Section 2704(b)(2).

agreements, such as those described in the Uniform Partnership Acts, the transfer of a partnership interest would result in the transferee's initial receipt of an assignee interest. Yet, Example 8 of the conference report concludes that because the family had the ability to remove the restriction on termination, the value of the bequeathed interest would be determined without regard to the restriction. The transitory assignee status of the interest in the hands of the transferee is simply not relevant to the analysis because the statute was designed to apply only to family controlled entities. Moreover, the assignee argument would render section 2704(b) meaningless in the context of partnerships. If the term "interest in a partnership" is read to refer to the character of the property in the hands of the transferee, the statute would never apply in the case in which it was clearly intended to apply, a generic partnership agreement as contemplated by the uniform acts, because under those acts both inter vivos and testamentary transfers automatically result in an assignee interest. The partnership interest bequeathed in Example 8, above, would itself not have been subject to section 2704(b).

The purpose of section 2704(b) is to disregard liquidation restrictions found in family controlled entities which reduce the value of the transferred interest under the willing buyer/willing seller test, but which do not ultimately reduce the value of the interest to the transferee. See section 2704(b)(4). The scope of section 2704(b) is confined to family entities. Here the transferred property was an LLC interest in the hands of the transferor. The family at all times had the power to remove any restrictions on liquidation, including any transitory assignee status inherent in the act of transfer. In this context, the term "interest in a partnership" cannot refer to the transitory character of the interest in the hands of the assignee.

5. Conversion of the transferred interests into assignee interests in the hands of the transferees triggers a transfer under I.R.C. § 2704(a)

Moreover, the argument that there is no applicable restriction to be disregarded under section 2704(b) must be viewed in light of section 2704(a). Section 2704(a)(1) provides that if (A) there is a lapse of any voting or liquidation right in a corporation or partnership, and (B) the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, such lapse is treated as a transfer by such individual by gift, or a transfer that is includible in the gross estate of the decedent, whichever is applicable. Section 2704(a) does not apply unless the interest holder and members of the holder's family can immediately after the lapse, liquidate the interest. Treas. Reg. § 25.2704-1(c)(2)(i)(A) and (B). In determining whether an interest can be liquidated after the lapse, restrictions described in section 2704(b) are disregarded.

The preamble to the section 2704 regulations states that the lapse of a liquidation right occurring by reason of state law is subject to section 2704(a), "because the shareholders or partners are free to alter the rules otherwise applicable under state law. Preamble to T.D. 8395, 1992-1 C.B. 316, 321. Thus, if an FLLC interest can vote on liquidation, and the holder transfers the interest with the result that under state law the transferee takes an assignee interest that cannot vote on liquidation, then the ability to vote on liquidation is treated as lapsing under section 2704(a).

Here, the member's ability to liquidate under state law is curtailed by the x percent requirement of the operating agreement. However, if the restriction on liquidation imposed by the operating agreement were disregarded under section 2704(b), the restriction should also be disregarded in applying section 2704(a). Thus, the transfer of the FLLC interest should be viewed as causing a lapse of a voting right where only y percent interest is required for liquidation.

D's estate may argue that the holder of an FLLC interest does not have a liquidation right before the transfer and thus, there was no lapse of a liquidation right. If this were correct, the statute would permit a transferor to use a restriction that is disregarded under section 2704(b) to avoid the application of section 2704(a). The application of the statute cannot be straddled in this manner.

Treas. Reg. § 25.2704-1(f)(Example 5) provides that D and D's two children are partners in X. Each has a general partnership interest and a limited partnership interest. Under the applicable state law, a general partner has the right to participate in partnership management. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. In the example, D dies leaving his limited partnership interest to his spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone. The example concludes that section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest.

Treas. Reg. § 25.2704-1(f)(Example 6) contains the same facts as Example 5, except that under the partnership agreement D is the only general partner who holds a unilateral liquidation right. The example further assumes that the partnership agreement contains a restriction described in section 2704(b) that prevents D's family members from liquidating D's limited partnership interest immediately after D's death. Under state law, in the absence of the restriction in the partnership agreement, D's family members could liquidate the partnership. The example concludes that the restriction on the family's ability to liquidate is disregarded and the amount of D’s gross estate is increased by reason of the lapse of D’s liquidation right.

Example 5 and Example 6 illustrate that a restriction that would be disregarded under section 2704(b) (in the examples, a provision restricting the ability of the family to liquidate immediately after the transfer) is also disregarded in applying section 2704(a). Similarly, a restriction on liquidation immediately before the transfer should be disregarded in applying section 2704(a). Therefore, prior to the transfers at issue, the LLC interest is treated as if the LLC can be liquidated by a vote of y percent in interest. Section 2704(a) applies to the lapse of that liquidation provision if, after the lapse (as is the case here), the members of the family could liquidate the LLC.

6. Applicability of § 2036

I.R.C. § 2036(a) provides that a decedent's gross estate includes the value of all property interests transferred (other than for full and adequate consideration in money or money's worth) by a decedent during his life where he retains for life, the possession, enjoyment of the property or the right to the income from the property or the right to designate the persons who will enjoy the property or the income therefrom. The term "enjoyment" refers to economic benefits from the property. Estate of Gilman v. Commissioner, 65 T.C. 296, 307 (1975), aff'd, 547 F.2d 32 (2nd Cir. 1976).

Retained enjoyment may exist where there is an express or implied understanding at the time of the transfer that the transferor will retain the economic benefits of the property. Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Rapelje v. Commissioner, 73 T.C. 82, 86 (1979). The understanding need not be legally enforceable. Estate of Rapelje v. Commissioner, supra; Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242.

Inclusion under section 2036 is dependent on whether the decedent retained an interest in property which has been transferred during life. The fact that the retained interest may be equal in value to the transferred property where, for example, property is transferred in trust and the decedent retains an income interest equal to the value of the property transferred, or where the power to revoke the transfer is equal to the value of the transferred property, does not answer the question. Rather, the question under section 2036 is whether the decedent retained the economic benefits of the assets transferred into the partnership pursuant to an implied understanding between the parties at the time of the transfer that the decedent would retain such benefits. See e.g., Bay v. United States, 762 F.2d 1361 (9th Cir. 1985); Lazarus v. Commissioner, 513 F. 2d 824 (9th Cir. 1975).

Only after it has been determined that a decedent's interest in transferred property constitutes a retained interest does the question of consideration become relevant.

Section 2036 addresses only the testamentary aspect of the transaction, i.e., the transfer of the underlying assets to the decedent's children subject to the decedents retained life estate, which life estate terminates on the decedent's death. It is only in this context that consideration is relevant. Typically, the decedent's children have provided no consideration to the decedent for the transfer. In the absence of any consideration flowing from the recipients of the remainder interest, the entire date of death value of the transferred property is includible in the decedent's gross estate.

In Estate of Reichardt v. Commissioner, 114 T.C. No. 9 (March 1, 2000), the decedent established a revocable living trust and a family limited partnership. The decedent appointed himself and his two children as co-trustees of the trust, and transferred virtually all his assets (including his house, brokerage accounts, and real property) to the partnership. He retained his car, some personal effects and a small amount of cash. The revocable trust was designated as the sole general partner of the partnership. Shortly thereafter, the decedent gave each of his children a 30.4% limited interest in the partnership. Decedent continued to live at his residence, paying no rent to the partnership for its use.

The record indicated that the decedent controlled and managed or allowed the co-owners to control and manage the partnership assets in the same manner both before and after he transferred his assets to the partnership. He used the same brokers both before and after he transferred the property to the partnership. Thus, the decedent's relationship to the assets did not change after conveyance to the partnership. The record also indicated that the partnership paid approximately $21,000 of the decedent's personal expenses in 1993 and 1994.

The court found that all the assets held in the partnership at the time of the decedent's death were includible in the gross estate under section 2036(a). Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242. The court found that there was an implied agreement at the time of the transfer that the decedent would retain the present economic benefits of the property. "Petitioner bears the burden (which is especially onerous for transactions involving family members) of proving that an implied agreement or understanding between the decedent and his children did not exist when he transferred the property at issue to the partnership."

The court relied upon the following evidence of the implied agreement:

1. Nothing changed except legal title. The decedent managed the trust which managed the partnership. The decedent was the only trustee to sign the articles of limited partnership and the deeds. The decedent

> was the only trustee to open brokerage accounts, or sign partnership checks.
>
> 2. The decedent commingled partnership and personal funds. The decedent deposited partnership income in his personal account. In addition he continued to live in his residence rent-free after the residence had been transferred to the partnership.
>
> 3. The decedent transferred virtually all his assets to the partnership. This implied that decedent had an implied agreement that he could continue to use those assets.
>
> 4. Although the decedent had a fiduciary duty as a general partner, this duty did not deter him from continuing to possess and enjoy partnership property (including the house), also indicating an implied agreement.

The court also concluded that the transfer of the assets to the partnership was not a "bona fide sale for adequate and full consideration in money or money's worth." The decedent's children gave nothing to the decedent or the partnership when he transferred the assets to the partnership. Further, the decedent's transfer of assets to the partnership in exchange for partnership interests was not a bona fide sale of assets, citing Wheeler v United States, 96-1 USTC ¶60,226 (W.D. Tex. 1996), rev'd, 116 F. 3rd 749 (5th Cir. 1997) ("A bona fide sale contemplates an arms-length business transaction between a willing buyer and a willing seller. Here, there was no negotiation of the purchase price of the property....").[6]

The factual record required to support the economic substance analysis discussed above may also support the application of section 2036, which turns upon whether there was an implied understanding at the time of the transfer that the transferor would retain the economic benefits of the property.

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[6]The Tax Court's decision in Estate of Reichardt should be contrasted with the court's earlier decision in Estate of Harrison v. Commissioner, T.C. Memo 1987-8, where the court found that the partnership in that case had a business purpose (providing necessary and proper management of decedent's properties and was advantageous and in the best interests of the decedent) and was not a testamentary device (the partnership agreement applied to all the partners, no partner could liquidate without the other partner's consent, decedent received adequate consideration for the transfer to the partnership, and although the partnership resulted in a substantial decrease in estate taxes, there was no "proof in the record that the partnership was created other than for business purposes.")

7. Applicability of Gift on Formation Argument

You have suggested that the gift on formation argument may be an appropriate alternative argument. The assertion that a donor's transfer of assets to a family controlled entity was an arm's length transaction for which he received adequate consideration (no gift) is inconsistent with the assertion that his interest on his death was worth substantially less than its pro rata share of the underlying assets. The estate and gift tax are in pari materia and must be construed harmoniously. Estate of Sanford v. Commissioner, 308 U.S. 39 (1939); Merrill v. Fahs, 324 U.S. 308 (1945). Consequently, if the value of the donor's interest at death is determined to be less than its proportionate share of the underlying assets, then the donor made a gift on the formation of the entity.

We do not recommend that the gift on formation argument be made on these facts. By virtue of the size of the interest D received on the formation of FLLC, under the terms of the management agreement, D retained control over all but the most mundane decisions and could liquidate the entity at will. Liquidation would result in the return to D of a pro rata share of the assets. Given D's retained powers, we doubt that a court could be convinced that D made a completed gift of any part of the assets allocable to D's FLLC interest on the formation of FLLC.

8, Attacking the Discount

If the taxpayer can show that the form of FLLC must be respected, the interests in it, and not the underlying assets, will be valued as the gifts and as part of the gross estate. The amount of the discounts, if any, must be established through the testimony of a qualified expert. We recommend the following considerations be presented to respondent's experts.

a) Trust Analogy A family limited partnership holding liquid assets is analogous to a trust for valuation purposes, for the primary purpose of both is to hold assets for protection and investment for ultimate distribution to the beneficiaries/partners. The role of the general partner, as manager of the assets and decision-maker regarding distributions, is analogous to that of a trustee. Both are subject to fiduciary duties toward the beneficiaries/partners. As a result, the nature of the partners' interests in a family partnership holding liquid assets is closely analogous to that of a holder of a beneficial interest in a trust.

If a donor transfers property to an irrevocable trust, the amount of the gift is the value of the assets transferred to the trust (or if the donor, for example, retains a life estate, the gift is the actuarial value of the remainder interest transferred.) Presumably, the result would be the same if the donor transferred property to a revocable trust and then relinquished the right of revocation over the entire trust at one time. The focus for valuing the gift is the value of the assets transferred by the donor, not the sum of the values of the trust interests received by the donees. Similarly, if the donor relinquished the right to revoke by making seriatim gifts of trust interests to the beneficiaries, the amount of the gift will be the value of the trust assets represented by the trust interest.[7] Thus the interests transferred should be valued like interests in a trust, i.e., with no discounts.

The valuation methodology that the courts have been using in valuing partnership interests originated in cases valuing interests in corporations conducting an active trade or business, and would be appropriate in cases where the partnership conducts an active trade or business. It is inappropriate, however, where the partnership is holding passive assets identical to those typically held in trust.

This argument is not that a family partnership is in substance a trust. Rather, in view of the similarities between the two entities, the same valuation methodology should be applied in valuing transfers with respect to both entities. While this argument is not dependent on the testimony of a qualified valuation expert, it does require a well-developed factual record describing the transaction, and the interests and roles of each of the parties.

b) Closed-end Mutual Fund Analogy The Joint Committee recently addressed the valuation of family partnerships holding readily marketable assets and suggested that they might be compared to publicly traded closed-end mutual funds. Staff of the Joint Committee on Taxation, 105th Cong., 2nd Sess. Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal 176, 178-79 (Jt. Comm. Print, February 24, 1998). Like a limited partner, a closed-end mutual fund investor owns an interest in a pool of liquid assets held for investment; the investor has no control over management of assets or the nature of the investments. Closed-end mutual funds generally trade at a discount from net asset value of 4-12 percent, a discount which is deemed sufficient by the public markets to reflect the disadvantages of a minority interest. We note that interests in family partnerships are not readily marketable, as is the case with mutual funds. Thus, it may be necessary to concede an additional discount for lack of marketability. This argument is a factual one which must be based on the opinion of a qualified valuation expert.

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[7] It is generally recognized that an interest in a trust would not be discounted in determining fair market value for gift tax purposes. For example, lack of control over management of investments, or lack of marketability would not be considered a relevant factor in view of the fiduciary duties of the trustee; this is especially the case if the trust holds liquid assets. Luton v. Commissioner, T.C. Memo 1994-539.

c) Publicly Traded Partnerships as Comparables. Taxpayers' experts ignore the publicly-traded partnership as a comparable. The appropriate willing buyer/willing seller price comparison should be the price the promoter charges, and the investor pays, when the units are initially sold to the public, rather than the price at which the units are later sold by the investor in the secondary market. Generally, on the initial offering, the investor is willing to pay full value for the partnership units (i.e., 100% of the net asset value represented by the partnership units purchased). Arguably, the family member receiving interests in a newly formed family limited partnership is in no different position from that of an investor purchasing publicly traded units in the initial public offering. Both are receiving an interest in a pool of liquid assets, and both have little control over the nature of the investments or the management of the assets. This argument is a factual one and must be based upon the opinion of a qualified expert.

d) Elements of Value

1) Business Purpose Factors Many of the factors cited by taxpayers as supporting the business purpose for forming the partnership, if valid, should enhance the value of the partnership interests, thereby offsetting some of the discounts claimed. For example, assuming a partnership interest does provide creditor protection, centralized management of the portfolio, and the benefits of pooling assets for investment, etc., the value of that interest should reflect these advantages. Similarly, restrictions on the other partners' ability to withdraw from the partnership or transfer their interests arguably enhance the value of the subject partnership interest. These restrictions ensure that the underlying partnership assets will remain intact, and that the partnership will have a long and stable existence. This argument is a factual one which must be based upon the opinion of a qualified expert.

2) The Willing Seller In applying the willing buyer/willing seller test, the willing seller would not sell his or her interest at a substantially discounted value. See Estate of Mandelbaum v. Commissioner, T.C. Memo 1995-255, aff'd, 91 F.3d 124 (3rd Cir. 1996). ("[T]he test of fair market value rests on the concept of a hypothetical willing buyer and a hypothetical willing seller. Ignoring the views of the willing seller is contrary to this well-established test.")

Under the Treas. Reg. § 20.2031-1(b) the hypothetical seller is under no compulsion to sell. Thus, it would seem unlikely that an individual who just transferred liquid assets of significant value to a family partnership and is under no compulsion to sell the partnership interest, would agree to sell that interest at a price significantly less than the value of the assets he transferred to the partnership. This argument is a factual one which must be based on the opinion of a qualified valuation expert.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[redacted]

Please call if you have any further questions.

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