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Person To Contact:
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Date: JULY 19, 2004

In Re:

Legend

Decedent -
Child 1 -
Child 2 -
Child 3 -
GST Trust -

Partnership -
Date 1 -
Date 2 -
$S -
$T -
X -
Y -
Z -

Dear :

This is in response to your March 17, 2004 letter and other correspondence requesting a ruling concerning the valuation, for Generation-Skipping Transfer (GST) Tax purposes, of certain interests over which an election for alternate valuation under § 2032A of the Internal Revenue Code was made.

According to the submitted information, Decedent died testate on Date 1, survived by 3 children; Child 1, Child 2, and Child 3, and other descendants. Child 1 is the executor of Decedent's estate. Included in Decedent's estate are X general and Y limited partnership units in Partnership, which is an operating farm business. Partnership has a total of Z general and limited partnership units. Assets of Partnership include farmland, among other assets.

Section III of Decedent's will divides into three equal shares property disposed of under Decedent's will that " . . . exceeds a sum equal to the largest amount, if any, that can pass free of the [GST tax] on the date of my death, and after taking account of any [GST] charged to me for transfers made during my lifetime, and after taking account of property disposed of by previous sections of this will and property passing outside of this will which is includable in my estate for [GST] tax purposes, and after taking account of charges to principal that are not allowed as deductions in computing my [GST] tax." The three shares are to be distributed to Child 1, and Child 2, and Child 3, or, if any of them predecease Decedent, to that child's living descendants, either outright or in trust. In satisfying this bequest, Decedent's will directs the executor, to the extent possible, to distribute personal property other than general or limited units in Partnership.

Section IV(a) of Decedent's will provides that the residue of Decedent's estate shall pass in trust, known as the GST Trust. Child 1 is the trustee of GST Trust. Under its terms, upon Decedent's death, the net income is distributed in equal shares to Child 1, Child 2, and Child 3. If any child should die before the GST Trust terminates, that child's share of the net income is to be distributed among Decedent's descendants and the parents of the descendants of the deceased child (other than the deceased child) as appointed by that child either by testamentary or inter vivos appointment. If the child fails to appoint the net income, it will pass to that child's descendants per stirpes or, if none, to the surviving children of Decedent and their descendants, per stirpes. The GST Trust will terminate upon the death of the last to die of Child 1, Child 2, and Child 3.

Section IV(f) of GST Trust provides that Child 1, Child 2, and Child 3, while they are all alive, may divide the trust into three separate and equal trusts. The separate trusts will be for the primary benefit of Child 1, Child 2, and Child 3, respectively, and will have the same dispositive provisions as set forth in section IV of Decedent's will, described above, except section IV(e).

Section IV(d) provides that, upon termination of the GST Trust, if the trust contains any general partnership units of Partnership, the trustee shall distribute the units pursuant to a power in Child 1 to appoint such units, except that such power is not exercisable in favor of Child 1, Child 1's estate or the creditors of either.

Section IV(e) provides that, except as provided in section IV(d) above, upon termination of GST Trust, if the corpus has not been divided among Child 1, Child 2, and Child 3 as described in section IV(f), each child will have the testamentary power to appoint an undivided one-third interest in the corpus and accrued and undistributed net income to descendants of Decedent, other than that respective child, that child's estate, or the creditors of either. Any share not appointed will be distributed to the respective child's descendants, per stirpes, or if none, to the appointees or descendants of Decedent's other children, per stirpes.

You represent that Decedent's estate timely filed a United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706, on or near Date 2. On the estate tax return, Decedent's estate elected to value the qualifying farm property in Partnership at its special use value as described under § 2032A. Decedent's estate included the X general and Y limited partnership units in Partnership on the estate tax return. The information submitted indicates that Decedent's estate attached to the estate tax return, the agreements signed by the interested parties consenting to personal liability under § 2032A(c) for additional estate tax and GST taxes by that subsection.

In valuing Decedent's general and limited partnership interests in Partnership, Decedent's estate computed the fair market value of the Partnership units by separately valuing Decedent's general and limited partnership units and applying discounts for lack of marketability and minority interests to the limited partnership units. Pursuant to this computation, Decedent's estate concluded that the fair market value of Decedent's interest in Partnership on Decedent's date of death was $S. Decedent's estate computed both the fair market value of Decedent's interest in Partnership assets that qualified for valuation under § 2032A and the value of those assets as determined under § 2032A. Decedent's estate concluded that the difference exceeded $770,000, and thus reduced the fair market value (arrived at by applying the discounts for minority interests and lack of marketability) of Decedent's general and limited partnership interests in Partnership by $770,000, the maximum reduction then allowed under § 2032A. This computation resulted in Decedent's estate including $T in Decedent's gross estate as the fair market value of Decedent's general and limited partnership interest in partnership valued under § 2032A. This amount was included on Decedent's estate tax return.

Based on Section III of Decedent's will, which directs the executor, to the extent possible, to fund the Section III bequest with assets other than Partnership units, much of Decedent's interests in Partnership will pass, pursuant to the residuary bequest, to GST Trust. Decedent's estate has represented that $ (the amount allowable in the year of Decedent's death) of Decedent's GST exemption was allocated to the GST Trust on Decedent's estate tax return.

You request a ruling that the proper method, for purposes of funding the GST Trust, is the method used by Decedent's estate in determining the fair market value of Decedent's interests in Partnership and reducing that value by the allowable reduction under § 2032A.

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a resident of the United States.

Section 2031 provides that the value of the gross estate of the decedent will be determined by including the value at the time of the decedent's death, all property, real or personal, tangible or intangible, wherever situated.

Section 20.2031-1(b) of the Estate Tax Regulations states that the value of property includible in the decedent's gross estate is its fair market value at the time of the decedent's death. The fair market value is 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.

However, § 2032A provides that if the executor elects the application of § 2032A and files the agreement described in § 2032A(d)(2), the value of the qualified real property included in the decedent's gross estate that is devoted to farming shall be valued on the basis of its use as a farm, rather than at its highest and best use (i.e., fair market value).

Section 2032A(a)(2) provides that the aggregate reduction in the value of the property taken into account for purposes of § 2032A cannot exceed $750,000 (adjusted for inflation under § 2032A(a)(3)).

Section 2032A(c) generally provides recapture provisions for additional estate tax in the event that the specially valued property is disposed of or no longer used in a qualified use under § 2032A within the ten year period following the decedent's death.

Section 2032A(d)(1) provides that the election to specially value real property shall be made on the return of the tax imposed by § 2001. Section 2032A(d)(2) provides that each person who has an interest in the property to be specially valued must sign an agreement consenting to the application of the recapture provisions set forth in § 2032A(c). Such election and written agreement is to be made in such manner as the Secretary prescribes by regulations. See § 20.2032A-8 of the Estate Tax Regulations.

Section 2601 imposes a tax on every generation-skipping transfer. A generation-skipping transfer (GST) is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate. Section 2641(a) provides that the term "applicable rate" means with respect to any GST transfer, the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under section 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the "applicable fraction". The applicable fraction, as defined in § 2642(a)(2) is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator of which is the value of the property transferred to the trust or involved in the direct skip.

Section 26.2642-2(b)(1) of the Generation-Skipping Transfer Tax Regulations provides that, in general, in determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for estate tax purposes. In the case of qualified real property with respect to which the election under § 2032A is made, the value of the property is the value determined under § 2032A provided the recapture agreement described in § 2032A(d)(2) filed with the IRS specifically provides for the signatories' consent to the imposition of, and personal liability for, additional GST tax in the event an additional estate tax is imposed under § 2032A(c). If the recapture agreement does not contain these provisions, the value of qualified real property as to which the election under § 2032A is made is the fair market value of the property determined without regard to the provisions of § 2032A.

Section 2631(a) provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of $1,000,000 (adjusted for inflation under § 2631(c)) that may be allocated by the individual (or his executor) to any property with respect to which the individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, is irrevocable.

Section 2632(a) provides that an allocation by an individual of his GST exemption may be made at any time on or before the date prescribed for filing the individual's estate tax return, including extensions) in a manner prescribed by regulations.

Section 26.2632-1(d)(1) provides that an allocation of decedent's unused GST exemption by the executor of the decedent's estate is made on Form 706 filed on or before the date prescribed for filing the return. An allocation of GST exemption to a trust (whether or not funded at the time the Form 706 or Form 706NA is filed) is effective if the notice of allocation clearly identifies the trust and the amount of the decedent's GST exemption allocated to the trust.

In Estate of Hoover v. Commissioner, 69 F.3d 1044, (10^{th} Cir. 1995), acq. 1998-2 C.B. 254, 1999-1 C.B. 5, the taxpayer elected special use valuation and valued the decedent's 26 percent interest in a family limited partnership, at $2,138,097. The limited partnership was engaged in the business of operating a cattle ranch. The $2,138,097 represented decedent's share of the limited partnership assets that qualified for special use valuation under § 2032A ($2,730,000), reduced by discounts totaling 30 percent for minority interests and lack of marketability and further reduced by $750,000, the then maximum reduction under § 2032A. When added to the decedent's 26 percent interest in other assets of the limited partnership also reduced by discounts totaling 30 percent, the total value of decedent's interest in the family limited partnership was reported on the decedent's estate tax return at $2,138,097.

The court concluded that the decedent's estate applied the proper methodology in valuing the decedent's interest in the limited partnership. The court stated that "[p]roper application of § 2032A(a)(2) must involve an accurate determination of fair market value, which necessarily incorporates the minority interest discount." The court concluded that the fair market value of the interest must first be determined and such determination under § 20.2031-1(b) would include the application of discounts. Upon election and qualification under § 2032A, the fair market value is then reduced to reflect its special use value. That reduction is limited to $750,000, adjusted for inflation, and is a reduction from the value that would otherwise have been reported if no § 2032A election was made.

The facts in Estate of Hoover, supra, are distinguishable from those in Estate of Maddox v. Commissioner, 93 T.C. 228 (1989), where the estate first computed the special use value of the decedent's interest and then attempted to reduce that value by a discount for a minority interest. The Tax Court concluded that an otherwise available minority discount for stock cannot further reduce the value of shares of stock in an incorporated farm where the corporate stock is valued under § 2032A. The Tenth Circuit in Estate of Hoover, at 1046, stated that "the tax court properly held that the estate could not take advantage of such a double reduction . . . ".

As noted above, in this case, as in Estate of Hoover, the decedent's estate computed the fair market value of the decedent's interest in the partnership (incorporating the discounts for lack of marketability and minority interests) and then applied the § 2032A valuation reduction to that fair market value. In arriving at that reduction, the estate computed the difference between the fair market value of the decedent's interest in the property interest that qualified for special use valuation under § 2032A, (incorporating the discounts for minority interests and lack of marketability) and the decedent's interest in the property valued at its special use under § 2032A (without any discount). In Decedent's estate, that difference exceeded the maximum allowable § 2032A reduction, which at that time was $770,000. Consistent with the methodology set forth in Estate of Hoover, the Decedent's estate reduced the fair market value (incorporating discounts) of decedent's interest in Partnership by $770,000 in determining the amount includible in Decedent's gross estate.

We have acquiesced with the decision in Estate of Hoover regarding the methodology used in determining the special use value under § 2032A of an interest in property where discounts for a minority interest or lack of marketability are incorporated in determining the fair market value of that property.

Thus, we conclude that a discount for a minority interest or lack of marketability is permitted in determining the fair market value of a property interest that is specially valued under § 2032A and that, for estate tax purposes, this method is the proper method for determining the value of Decedent's interest in Partnership that has been valued under § 2032A. Because the interested parties of the specially valued property interest have consented in the written agreement to the imposition of, and personal liability for, additional GST tax in the event an additional estate tax is imposed under § 2032A(c), the value of the property for GST allocation purposes is the value determined under § 2032A. See § 26.2642-2(b)(1).

Accordingly, we rule that, for purposes of funding the GST Trust created under Section IV of Decedent's will and allocating the Decedent's unused GST exemption to that trust, the value of the property interests in the trust will be its value for estate tax purposes. In this case, the proper method is the method used by Decedent's estate in determining the fair market value of Decedent's interests in Partnership (incorporating appropriate discounts) and reducing that value by the allowable reduction under § 2032A.

The rulings contained in this letter are based upon information submitted and representations made by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. We are specifically not ruling on the values of any property interest that has been reported on Decedent's estate tax return.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
Associate Chief Counsel
(Passthroughs and Special
Industries)

____
By: Lorraine E. Gardner,
Senior Counsel, Branch 4

Enclosures
Copy for section 6110 purposes
Copy of this letter