

8th Circuit Rules Transfer Restrictions Properly Disregarded in Family Partnership Case

BY SCOTT E. VINCENT

The 8th Circuit recently affirmed a key Tax Court case disregarding transfer restrictions in valuing gifts of interests in a family limited partnership. *Holman, Jr. v. Comm.*, 105 AFTR 2d 2010-1802 (April 7, 2010). This decision has significant implications for estate tax gifting programs and for the overall family limited partnership structure for transferring wealth to family members.

Background

Thomas H. Holman, Jr. and Kim D.L. Holman (the donors) created a limited partnership, funded it with common stock of Dell, Inc., and gifted limited partnership shares to their children. In a gift tax return, the donors asserted lack-of-marketability and minority-interest discounts to claim a value for the gifts substantially below the value of the underlying Dell stock.

The donors relied in part on transfer restrictions contained in the partnership agreement, and asserted that the transfer restrictions would depress the value of the partnership shares relative to the value of the underlying assets.

The IRS challenged the gift tax return, characterizing the gifts as gifts of Dell stock rather than gifts of limited partnership shares. In addition, the IRS applied Internal Revenue Code § 2703 to disregard the partnership agreement's transfer restrictions for valuation purposes. The IRS agreed that lack-of-marketability and minority-interest discounts should apply in valuing the gifts, but asserted that the discounts should be smaller than those claimed by the donors.

The Tax Court held that the gifts were gifts of limited partnership shares. However, the Tax Court held that the IRS correctly applied § 2703 to disregard the partnership agreement's transfer restrictions. The Tax Court also applied smaller lack-of-marketability and minority-interest discounts than claimed by the donors. In doing so, the Tax Court adopted the lack-of-marketability discount as asserted by the IRS expert based on historical studies of restricted stock sales. The Tax Court noted that the partnership held only highly liquid, easily valued assets, and that the agreement contained a

consensual dissolution provision and granted broad management discretion to the general partners. According to the Tax Court, because economically rational actors would take advantage of the dissolution provision to dissolve and reconstitute the partnership or otherwise buy out a departing partner, there was a natural cap on any lack-of-marketability discount.

On appeal to the 8th Circuit, the donors challenged the Tax Court's application of § 2703, its determination of marketability and minority-interest discounts, and its overall valuation determination. The 8th Circuit affirmed the judgment of the Tax Court on these issues. The issue examined here is the application of § 2703.

Background on Transfer Restrictions

Restrictions on the sale or use of property generally tend to depress the value of the property. Oftentimes, they serve legitimate business purposes, impose actual and meaningful limitations on the use or transferability of property, and are accepted by parties dealing with one another in arms-length transactions. When carefully crafted and applied in certain circumstances, however, these restrictions can minimize the tax consequences of gifts or transfers without imposing substantial additional limitations on the transferability or use



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of the property, especially in the context of family transfers. Because of these perceived abuses, Congress enacted § 2703(a), which broadly prohibits consideration of restrictions for valuation purposes for agreements created or substantially modified after October 8, 1990. Section 2703(b) was also enacted to allow taxpayers to prove eligibility for an exception that permits valuation based on these restrictions under certain circumstances. To be eligible for the exception and gain the benefit of having restrictions considered for valuation purposes, the taxpayer must satisfy the following three-part test:

- the restriction must be “a bona fide business arrangement”;
- it must not be “a device to transfer such property to members of the decedent’s family for less than full and adequate consideration”; and
- its terms must be “comparable to similar arrangements entered into by persons in an arms’ length transaction.”

Valuation Restrictions Disregarded

The Tax Court concluded that Section 2703(a) applied because the bona fide business and device tests were not met. The 8th Circuit agreed that the bona fide business test was not met, and therefore agreed that § 2703(a) applied without the need to determine whether the other tests applied were met.

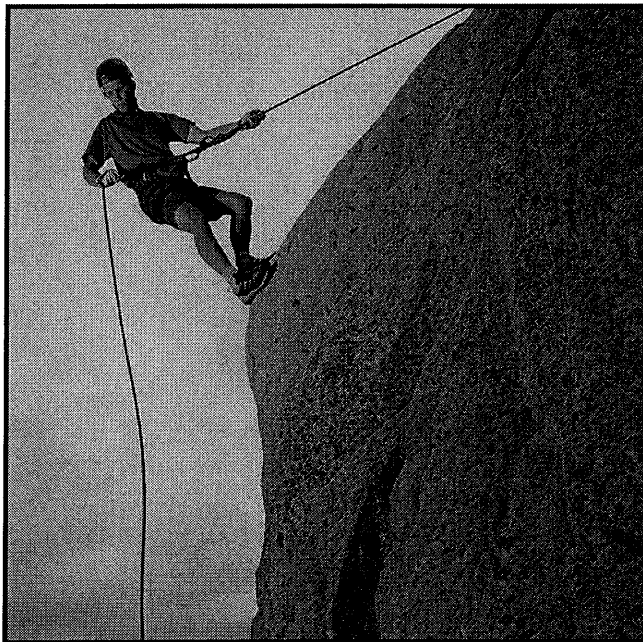
The 8th Circuit considered the entirety of the surrounding transactions and found that the following factual circumstances supported the Tax Court’s determination:

- the contemporaneous execution of wills;
- Mr. Holman’s understanding of the potential tax benefits of his actions;
- Mrs. Holman’s educational goals; and
- the absence of any business activity.

The court observed that, when viewed in this context, there was little doubt that the restrictions included in the Holmans’ limited partnership agreement were not a bona fide business arrangement. Rather, they were predominantly for purposes of estate planning, tax reduction, wealth transfer, protection against dissipation by the children, and teaching the children how to manage wealth.

Conclusion

The Holman case continues the trend of recent IRS successes in challenging wealth transfer through family limited partnership and family limited liability cases. With the estate tax scheduled to be back in effect in 2011 with much lower applicable credit shelter amounts, the IRS will certainly continue to press these cases, and estate tax planning with valuation discounts will have to be carefully considered and structured in light of the changing trend.



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