

COMPLEX TRANSFER TAX LITIGATION

ESTATE PLANNING COUNCIL OF BIRMINGHAM, INC.

BIRMINGHAM, ALABAMA

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I. OVERVIEW

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

II. BASIC VALUATION PRINCIPLES

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

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

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

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See, e.g.,* PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 9730004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997);

and PLR 9723009 (February 24, 1997). Since those pronouncements were issued, a number of these arguments have been decided by the courts.

A. I.R.C. § 2703 Argument

Sec. 2703. Certain Rights and Restrictions Disregarded

(a) GENERAL RULE--For purposes of this subtitle, the value of *any property* shall be determined without regard to--

(1) any option, agreement, or other right to acquire or use *the property* at a price less than the fair market value of *the property* (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use *such property*.

(b) EXCEPTIONS--Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

I.R.C. § 2703 (emphasis added).

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

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

2. I.R.C. § 2703 Can Effect the Value of the Interest Transferred

In *Estate of Blount v. Comm'r*, T.C. Memo 2004-116 (May 12, 2004), the Tax Court addressed the question of whether the redemption price in a modified buy-sell agreement controlled the value of a decedent's closely-held stock for federal estate tax purposes. The decedent ("D") and his brother-in-law each owned 50% of the outstanding shares of stock in a construction company. In 1981, D, his brother-in-law, and the company entered into an agreement that restricted transfers of the company stock during both the shareholder's lifetimes

and at death. The agreement required the company to buy a deceased's stockholder stock at an established price. Unless redetermined by the parties to the agreement, the purchase price would be equal to book value. In 1992, the company created an ESOP. The ESOP later became a third minority shareholder. After the redemption of the brother-in-law's shares following his death in January 1996, D's shares constituted a controlling 83.2% interest in the company.

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

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

In *Holman v. Comm'r*, 130 T.C. 12 (2008), the IRS argued that a right of first refusal contained in the partnership agreement should be ignored under § 2703. The right of first refusal permitted the Partnership (and if not exercised, the partners) to purchase an interest transferred to a "non-permitted transferee" at fair market value (i.e. after considering applicable lack of control and lack of marketability discounts). Applying the three part test of § 2703(b), the Tax Court determined that the right of first refusal and related transfer restrictions were not part of bona fide business arrangement. The Court noted that § 2703 contains no definition of the phrase "bona fide business arrangement." The Court stated that the provisions "do not serve bona fide business purposes because from its formation through the date of the 2001 gift, the Partnership carried on little activity other than holding shares of Dell stock." Despite undisputed testimony from the taxpayers that one of the primary purposes of the buy-sell provisions was to prevent transfers of interests outside of the family and to preserve the assets contributed to the Partnership, the Court held that § 2703(b)(1) had not been satisfied because the purposes of the Partnership (in the Court's view) did not include the operation of a closely held business.

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

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

The dissenting judge opined that the Holmans had satisfied the three required elements under § 2703(b). The dissent reasoned that the Holmans’ goals of maintaining family control over the partnership, including the rights to participate as a partner and receive income, and protecting assets from outside creditors, were included as legitimate purposes in the legislative history of § 2703(b)(1). The dissent also noted that the Tax Court did not properly apply the willing buyer and the willing seller test in determining the lack of marketability discount for the partnership interests because it assumed that the hypothetical buyers already owned Holman limited partnership interests, in violation of the Tax Court’s holding in *Estate of Jung v. Comm’r.*, 101 T.C. 412, 438 (1993). The dissent noted that the “Tax Court’s analysis is essentially based on the idea that a mere rational economic actor in the existing market would pay less than rational actors who already hold Holman limited partnership interests. Courts commit legal error where, as here, they substitute hypothetical buyers for ‘particular possible purchases’ based on ‘imaginary scenarios as to who a purchaser might be.’” *Id.* at 34, citing *Estate of Simplot v. Comm’r.*, 249 F.3d 1191, 1195 (9th Cir. 2001).

B. The Indirect Gift/Gift on Formation Argument

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

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

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

2. A Partner Cannot Make a Gift to Herself

The IRS's claim that a gift on formation of the Partnership occurred also suffers from another fatal flaw -- a partner cannot not make a gift to herself. Assume that at formation, Mrs. Jones owned a 90% partnership interest in the partnership, and other family members own the rest. The partnership is pro rata and each family member received an interest in the partnership equal to the value of the assets contributed. The IRS would argue that because the value of Mrs. Jones' interest in the partnership was worth less than the assets she contributed, she has made a gift equal to the difference between the value of the assets received and the value of the assets transferred. If a gift was made by Mrs. Jones, she was the recipient of 90% of that gift. *See Kincaid v. United States*, 682 F.2d 1220, 1225 (5th Cir. 1982) (noting that the taxpayer could not make a gift to herself when she transferred her ranch to a newly formed corporation that she and her two sons owned all of the voting stock, the Court held that she had made a gift to each of her sons of one-third of the total gift amount); *Estate of Hitchon v. Comm'r*, 45 T.C. 96 (1965) (father's transfer of stock to a family corporation for no consideration constituted gift by father of one-quarter interest to each of three shareholder sons).

On the other hand, in *Shepherd v. Comm'r*, a father and his two sons created a partnership and the father, at creation, transferred all of the assets to the partnership, and the sons made no individual capital contribution, the Tax Court held that the father had made gifts of undivided interests in the real estate and securities transferred to the partnership to the extent those properties were attributed to his sons' capital accounts. *Shepherd v. Comm'r*, 115 T.C. 30, 115 T.C. 376 (2000). The Court reasoned that because a partnership of one cannot exist, the father made indirect gifts of the property transferred to the partnership, and not of the partnership interests that the sons received. In language which should give some level of comfort to creators of pro rata partnerships, the Tax Court stated that “obviously, not every capital contribution to a partnership results in a gift to the other partners, particularly where the contributing partner's capital account is increased by the amount of the contribution, thus entitling him to recoup the same amount upon liquidation of the partnership.” *Id.* at 389. The Court also held, however, that the transfer should be treated as separate transfers of 25% to each son, and applied undivided interest discounts in determining the value of the gifts.

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

The Tax Court dealt the IRS’s gift on formation a significant blow in *Estate of Jones v. Comm’r*, 116 T.C. 121 (2001). In that case, Mr. Jones formed a family limited partnership with his son and transferred assets including real property in exchange for a 95.5389% limited partnership interest. He also formed a family limited partnership with his four daughters and transferred real property to it in exchange for an 88.178% limited partnership interest. The son contributed real property in exchange for general and limited partnership interests in the first partnership, and the daughters contributed real property in exchange for general and limited partnership interests in the second partnership. All of the contributions were properly reflected in the capital accounts of the contributing partners. The IRS argued that Mr. Jones made taxable gifts upon contributing his property to the partnerships. “Using the value reported by decedent on his gift tax return, the IRS argues that, if decedent gave up property worth \$17,615,857 and received back limited partnership interests worth only \$6,675,156, decedent made taxable gifts upon the formation of the partnerships equal to the difference in value.” *Id.* at 127.

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

In *Senda v. Comm’r*, T.C. Memo 2004-160 (July 12, 2004), husband and wife (“H and W”) signed a partnership agreement on April 1, 1998, and the certificate of limited partnership was issued on June 3, 1998. On December 28, 1998, H and W contributed approximately \$1.8 million worth of MCI WorldCom stock to a partnership, and their children purportedly transferred oral accounts receivable for their partnership interests (which were .10% limited partnership interests). The accounts receivable were never reduced to writing, had no

terms for repayment, and had not been paid as of the time of trial. On that same day, H and W sent a facsimile to their accountant to inform him of the transfer of stock and (except for charges) to ask what percentage of the limited partnership interest they should transfer to their children. Later that day, H gave each child a 29.94657% LP interest, and W gave each child a .0434% LP interest. The court noted that “the certificates of ownership reflecting these transfers were not prepared and signed until several years thereafter.”

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

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

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

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

With respect to the November 8, 1999, transfers, the IRS argued that (1) the taxpayers had made an indirect gift of Dell stock and not of the partnership units, and (2) the formation, funding and gifts of partnership units were steps in an integrated donative transaction and that once the intermediate steps are collapsed, the taxpayers’ gifts are of Dell stock “in the

form of partnership units.” The IRS did not make the same arguments with respect to the 2000 - 2002 gifts.

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

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

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

In *Linton v. United States*, 638 F. Supp.2d 1277 (W.D. Wash. 2009), the district court held in summary judgment proceedings that the taxpayers’ transfer of property to an LLC

on the same day that gifts of LLC interests were made to a trust for their children resulted in indirect gifts of the underlying assets.

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

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

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

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

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

to the trusts and, alternatively, that the step transaction doctrine applied to eliminate the valuation discounts.

Applying the same analysis as the court did in *Linton*, the court held that the facts were very similar to those of *Senda* and *Linton*, in that the transfer of assets to the LLC and gifts of interests in the LLC were made on the same day and the taxpayers could not prove which happened first. With respect to the step transaction doctrine, the court again distinguished *Holman* and *Gross* on the basis that there was no delay between the date of funding and the date of the gifts and that the nature of the gifts (cash) was such that the taxpayers could not establish that there was any real economic risk that the LLC units would change value between the time of the funding and the gifts of LLC units. Finding that the “end result test” (which is based on whether a “series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result”) was satisfied because the donors “clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of ‘prearranged parts of a single transaction.’” The court also held that the “interdependence test” of the step transaction doctrine had been satisfied because “it is clear from the record that but for the anticipated discount in calculating gift taxes, based on a low market appeal of the family LLC’s structure, plaintiffs would not have transferred the cash into investments LLC.”

C. Disregarded Entities/Step Transaction

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

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

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

The Majority decision of the Tax Court (authored by Judge Wells and joined by Judges Cohen, Foley, Vasquez, Thornton, Marvel, Goeke, Wherry, Gustafson, and Morrison) analyzed the historical gift tax valuation regime and held that the check-the-box regulations do not explicitly alter “the long-established federal gift tax valuation regime.” The Majority noted

that Congress has enacted provisions of the Internal Revenue Code (e.g., Chapter 14) that disregard valid state law restrictions in valuing transfers. In those cases, however, Congress expressly provided exceptions to address perceived valuation abuses. In the absence of explicit Congressional action and in light of the mandate in § 7701(a) that the check-the-box provisions apply only where the application is not “manifestly incompatible with the intent” of the Internal Revenue Code, the Majority held that Congress did not intend to eliminate entity related discounts for single member LLC’s in a gift tax context.

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

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

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

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

D. Annual Exclusion Gifts

1. *Price v. Comm'r*

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

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

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

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

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

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

The Court also determined that the donees did not have the right to immediate use, possession, or enjoyment of income from the property. The Court's analysis centered on the fact that pursuant to the partnership agreement, profits of the partnership were distributed at the discretion of the general partner. The Court noted that the partnership's income did not flow steadily to the donees, as there were no distributions in 1997 or 2001 (despite substantial distributions in other years totaling approximately \$500,000), and according to the partnership

agreement the “annual or periodic distributions to the partners are secondary to the partnership’s primary purpose of achieving a reasonable, compound rate or return, on a long-term basis, with respect to its investments.”

Thus, the Court held that the taxpayers were not entitled to annual exclusions for their gifts of partnership interests.

2. *Fisher v. United States*

In *Fisher v. United States*, 105 A.F.T.R.2d 2010-1347 (S.D. Ind.) (Mar. 11, 2010), the District Court held that gifts of LLC interests did not constitute present interests that qualified for the federal gift tax annual exclusion.

During 2000 – 2002, Mr. and Mrs. Fisher transferred membership interests in a family LLC to each of their seven children. During the years the gifts were made, the LLC’s principal asset was a parcel of undeveloped beach property. The Fishers initially claimed the annual exclusion for each transfer. The IRS assessed a deficiency of additional gift tax. The Fishers paid the deficiency and filed a claim for refund, alleging, in part, that the gifts of membership interests in the LLC were gifts of present interests.

The operating agreement provided for the LLC to be managed by a committee (which consisted of Mr. and Mrs. Fisher) that would appoint a general manager who would determine the timing and amount of all distributions from the LLC. The operating agreement provided that any distributions would be made pro-rata. Mr. Fisher was appointed as general manager.

The operating agreement also allowed members to transfer their right to a share of the LLC’s profits and losses and the right to receive distributions, subject to a right of first refusal held by the LLC. If the LLC exercised this right of first refusal, it could pay the transferring member with a non-negotiable 15-year promissory note providing for equal annual installments of principal and interest, beginning one year after the closing date. These transfer restrictions applied in all instances except for transfers to the Fishers or their descendants.

The Court construed the present interest requirement under § 2503 as follows:

Internal Revenue Code provisions dealing with exclusions are matters of legislative grace that must be narrowly construed. . . . The sole statutory distinction between present and future interests lies in the question of whether there is postponement of enjoyment of specific rights, powers or privileges which would be forthwith existent if the interest were present. . . . In other words, the phrase ‘present interest’ connotes the right to substantial present economic benefit.

Id. citing *Hackl v. Comm’r.*, 118 T.C. 279 (2002), *aff’d*, 335 F.3d 664 (7th Cir. 2003). The Court went on to state that “[u]nless the donee is entitled unconditionally to the present use, possession, or enjoyment of the

property transferred, the gift is one of a future interest.” *Id.*, citing *Stinson Estate v. United States*, 214 F.3d 846, 849 (7th Cir. 2000).

The Fishers first argued that the LLC units were present interests because the donees received the unrestricted right to receive distributions from the LLC. The Court held this right did not satisfy the present interest requirement under § 2503, noting that under the operating agreement, any potential distribution “was subject to a number of contingencies, all within the exclusive discretion of the General Manager.” The Court thus held that the right of the donees to receive distributions from the LLC was not a right to a ‘substantial present economic benefit.’

The Fishers next argued that the donees received the unrestricted right to possess, use, and enjoy the LLC’s primary asset -- the beach front property. The Court was not persuaded, stating “the right to possess, use, and enjoy property, without more, is not a right to a ‘substantial present economic benefit.’ . . . [rather, it] is a right to a non-pecuniary benefit.”

Finally, the Fishers asserted that the donees received the unrestricted right to unilaterally transfer their interests in the LLC. The Fishers argued that this right is a present interest in property. The Court again rejected the Fishers’ argument, stating that “due to the conditions restricting the [donee’s] right to transfer their interests in [the LLC], it is impossible for the [donees] to presently realize a substantial economic benefit.”

The Court thus held that the transfers of interests in the LLC from the Fishers to the donees were transfers of future interests in property and, therefore, not subject to the gift tax exclusion.

E. I.R.C. § 2036(a)

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

(a) GENERAL RULE—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

F. Recent § 2036 Cases

1. *Estate of Murphy v. United States*

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

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

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

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

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

Mr. Murphy made annual exclusion gifts of partnership interests to his children, their spouses and his grandchildren. At the time of his death, he owned a 95.25365 percent limited partnership interest and a 49 percent interest in the LLC. The assets of the partnership grew to \$131.5 million at the time of his death. Mr. Murphy's estate reported the value of his

95.25 percent limited partnership interest at \$74 million, based upon a combined 41 percent discount for lack of control and lack of marketability.

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

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

In its Findings of Fact and Conclusions of Law issued October 2, 2009, the court held that § 2036 did not apply to the partnership because the creation of the partnership qualified for the bona fide sale for adequate and full consideration under § 2036. The court found that the purpose of the partnership included pooling the family’s legacy assets into one entity to be centrally managed in a manner that was consistent with Mr. Murphy’s long-term business/investment philosophy. The court noted that Mr. Murphy’s youngest son was actively involved in the management of the partnership’s assets, and the partnership purchased and managed property consistent with the goal of acquiring and maintaining the family’s historical assets. The court also noted that Mr. Murphy retained \$130 million of assets outside of the partnership, he did not treat the partnership assets as his own and did not commingle assets of his own with the partnership’s assets. Finally, the court noted that the children who were involved with the partnership took an active role in its formation, and Mr. Murphy’s daughter was represented by her own attorney.

2. *Estate of Black v. Comm’r*

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

Mr. Black and members of his family were the second largest shareholders of stock in Erie Indemnity Company. Mr. Black had previously made gifts of his Erie stock to his son and to two trusts set up for the benefit of his grandsons. In 1993, Mr. Black, his son, and the two trusts contributed their Erie stock to Black Limited Partnership (“Black LP”), a family limited partnership, in exchange for partnership interests in proportion to the fair market value of their respective contributions. The principal reasons for creating Black LP included: (i) perpetuating Mr. Black’s buy-and-hold investment philosophy with respect to the Erie stock; (ii) placing the family’s Erie stock under greater investment controls; (iii) allowing the Black family to maintain a seat on the board of directors and giving the family potential “swing vote”

powers; and (iv) protection against future creditors and failed marriages. Of the Erie stock contributed to the partnership, Mr. Black contributed almost \$69 million, his son contributed over \$11 million, and the trusts for his grandchildren contributed almost \$1 million.

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

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

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

- (1) The participants in the entity at the issue received interests proportionate to the value of the property each contributed to the entity;
- (2) the respective contributed assets were properly credited to transferors' capital accounts;
- (3) distributions required negative adjustments to distributee capital accounts; and
- (4) there was a legitimate and significant nontax reason for the formation of the entity.

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

3. *Shurtz v. Comm'r*

In *Shurtz*, T.C. Memo 2010-21 (Feb. 3, 2010), the Tax Court determined that the value of property transferred to a family limited partnership by the decedent was not includable in her gross estate pursuant to § 2036(a) because the creation of the partnership satisfied the "bona fide sale for adequate consideration" exception.

In 1993, at least 14 Barge family members held separate undivided interests in the Barge timberland. The Barge family was concerned that their business would not function with so many undivided interests, and C.A. Barge Timberlands, L.P. ("Timberlands LP") was formed

to operate the business. Barge Timberlands Management, Inc. (“BTM”) was incorporated to be the general partner of Timberlands LP. BTM’s sole asset was a 2% general partnership interest in Timberlands LP. Mrs. Shurtz, the decedent, was a one-third owner of BTM’s stock at the time of her death; Richard Barge and Betty Morris, her siblings, also owned one-third interests each. Mrs. Barge owned a 16% limited partnership interest in Timberlands LP as well.

Not long after the establishment of Timberlands LP, Mrs. Shurtz, her siblings, and their respective spouses sought the advice of an attorney. Their main concern was the protection of the family’s interest in the Barge timberland from the litigious environment in Mississippi. To protect against this environment, they formed Doulos L.P. and contributed their direct timberland holdings and their interests in Timberland LP to Doulos L.P.

The IRS argued that the value of the assets contributed to Doulos L.P. were includable in Mrs. Shurtz’s gross estate by reason of her retention of the control, use, and benefit of the assets under § 2036. The estate claimed that § 2036(a) did not apply because the transfer to Doulos L.P. constituted a “bona fide sale for adequate and full consideration.”

The Tax Court analyzed this issue in light of *Bongard* and *Bigelow*, which stated that “the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred.” *Id.* The Court found several nontax reasons for establishing Doulos L.P. The two main reasons were to protect the interests from the litigious atmosphere in Mississippi and to facilitate the management of the timberland. The Court further found that each partner received an interest in Doulos L.P. that represented adequate and full consideration because (1) the contributors received interest in Doulos L.P. proportionate to the ownership interest each contributed, (2) the respective assets contributed were properly credited to each partner’s respective capital account, (3) distributions from Doulos L.P. required a negative adjustment in the distributee partner’s capital account, and (4) the presence of a legitimate and significant nontax business reason for the establishment of Doulos L.P.

The Court’s bona fide sale finding was rendered despite the existence of certain “bad facts” that have caused trouble for other taxpayers in § 2036(a) cases. Those facts included (1) Doulos L.P. did not maintain books of account; (2) Doulos L.P. did not establish a bank account until nearly 4 months after the partnership was established; (3) Mrs. Shurtz and her husband paid some of Doulos L.P.’s disbursements from their personal bank account and were only reimbursed for some of those payments (the payments not reimbursed were credited to their capital accounts); and (4) distributions from Doulos L.P. to its partners were not always proportional (however, disproportionate distributions were made up in subsequent years).

* * * * *

Factors examined by the courts in deciding whether § 2036 applies are case specific and continue to be developed through litigation and in the appeals of decisions such as *Strangi* and *Thompson*. "Formation" facts looked at by the courts have included: (1) the non-tax reasons for creating the entity; (2) whether the other partners made real contributions of property or services; (3) whether the decedent had sufficient assets outside of the partnership to live on;

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

IV. APPEALS COORDINATED ISSUES SETTLEMENT GUIDELINES

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

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

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

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

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

V. DEFINED VALUE OR FORMULA TRANSFERS

In an environment where the continued long-term existence of the federal estate tax has become uncertain, estate planners are discovering that clients are becoming hesitant to engage in transfer tax planning transactions that trigger a substantial gift tax. One of the techniques increasingly used by planners to attempt to cap gift tax exposure with respect to a gift or sale transaction involving a hard to value asset is a formula clause. These clauses are designed to limit the transferor’s gift exposure by either adjusting the value of the interest transferred to the extent a different value is “finally determined for gift tax purposes” (a “value adjustment clause”) or specifying the dollar value of the interest transferred (a “defined value clause”).¹

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax.

A. Value Adjustment Clauses

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

The IRS has taken the position that such clauses should be ignored for transfer tax purposes, asserting that the clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS’s and the court’s time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the formula clause kicks in to adjust the transaction so that no gift tax is owed.

¹ See, *e.g.*, Moore, *Attempting to Achieve Finality in Potentially “Open” Transactions*, U. OF MIAMI INST. ON EST. PLANNING 13 EST., GIFTS & TR. J. 83 (1988); Moore and Buchanan, *Valuation and Readjustment Clauses: What’s Possible?*, 45TH NYU TAX INST. (1987); McCaffrey and Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 TRUSTS AND ESTATES 47 (Oct. 1986).

Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS. Over the years, several value adjustment clauses have been tested in the courts, with the results generally favoring the IRS's position that the gift tax consequences of the transfer should be determined without regard to the clause.

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

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for federal gift tax purposes . . ." to exceed \$2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

Taxpayers, however, are not without a court victory upholding a value adjustment clause. In *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the taxpayer sold stock to trusts for his children for \$1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales agreements provided that "if the fair market value . . . as of the date of . . . [the agreement] is ever determined by the Internal Revenue Service to be greater than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." 545 F.2d at 703-04. The IRS took the position that the shares were worth more than \$1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the

trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction.

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

B. Value Definition Clauses

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a \$1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of \$1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011, the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter, Ward*, and their progeny.

C. *McCord v. Comm’r*

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

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51

(1958)), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of \$6.9 million. Thus, the value of the gift to the sons and the trusts was equal to \$6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS. Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See, e.g.*, Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the treasury regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Reg. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount passing to charity under a charitable trust. Treas. Reg. § 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes); Treas. Reg. § 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made). *See also* Rev. Rul. 72-392, 1972-2 C.B. 573, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

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

The Tax Court rejected the IRS's claim that the charitable deduction should be limited by the amount that the charity received because either the substance over form doctrine, public policy considerations, or the integrated transaction doctrine. On May 14, 2003, the Tax Court issued its opinion in *McCord v. Comm'r*, 120 T.C. 358 (2003). However, a majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement

signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred.

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

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

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

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

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

D. *Estate of Christiansen v. Comm’r*

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

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

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

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

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

The settlement caused an additional \$3.1 million of value to pass to the CLAT and the Foundation as a result of the disclaimer. If those transfers qualified for the estate tax charitable deduction, there would be no additional estate tax. A majority of Tax Court held that the disclaimer was not a qualified disclaimer as to the 75% portion that passed to the CLAT². The majority opined that the disclaimed property did not meet the requirements of § 2518 because Mrs. Christiansen’s daughter retained her contingent remainder interest in the CLAT. As to the 25% passing to the Foundation, there was no question that the disclaimer satisfied § 2518. However, the IRS challenged the formula disclaimer on two theories. First, the IRS

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

argued that any increased amount passing to the Foundation was contingent on a condition subsequent. Second, the IRS argued that the formula clause based on values “as finally determined for federal estate tax purposes” was void as contrary to public policy based on *Proctor*.

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

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

Id. at 15-16.

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

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

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

Id. at 17.

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

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

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

* * *

It seems clear, then, that references to value 'as finally determined for estate tax purposes' are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of \$6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a 'qualified disclaimer.' 26 U.S.C. § 2518(a). We find no support for the Commissioner's assertion that his challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

(Emphasis in original.)

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

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

E. *Estate of Petter v. Comm'r*

The application of *Procter* to a defined value transfer was at issue in *Estate of Petter v. Comm'r*, T.C. Memo 2009-280 (2009). In *Petter*, the taxpayer made a lifetime defined-value transfer of units of the Petter Family L.L.C. worth a specific value to trusts for her two children, with the excess portion over that specified value passing to charities, and with the division of the units to be based on values as finally determined for tax purposes. The gift documents required the trusts to transfer any excess units to the charities if the value of the units initially received was finally determined for tax purposes to exceed the defined-value amount. Similarly, the charities agreed to return any excess if the reverse were true.

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

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

don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits.” *Petter* at *14.

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

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

Id. at *15.

The Tax Court thus upheld the defined-value structure. In its opinion, the Tax Court drew something of a bright line between *Procter*-style savings clauses, on the one hand, and formula clauses like *Petter*, *Christiansen*, and *McCord*, on the other hand. The Tax Court noted that the “distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter*. . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine.” *Id.* at *12.

VI. VARIOUS VALUATION ADJUSTMENTS

A. Unrealized Capital Gains

In *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998), the Tax Court recognized the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation for the first time since the repeal of the General Utilities doctrine. At issue in *Davis* was the gift tax value of two 25 share blocks of stock (of the total of 97 shares) of A.D.D. Investment & Cattle Company (“ADDIC”) to each of two sons. ADDIC was a family owned holding company, the assets of which included over 1% of the issued and outstanding

common stock of Winn-Dixie, listed on the New York Stock Exchange, and assets related to ADDIC's cattle operations. ADDIC assets had a total built-in capital gains tax liability of \$26.7 million, about 96% of the gain being attributable to its Winn-Dixie stock. The Court allowed a \$9 million adjustment for built-in capital gains tax, representing approximately 1/3 of the total capital gains tax liability on all of the corporate assets. The petitioner's two experts and the IRS's expert (but not the IRS) believe that an adjustment was warranted -- that is, a willing buyer and a willing seller would have taken the built-in tax liability into account in arriving at a purchase price for the stock. The dispute was over the amount of the adjustment. The Court found that the full amount of built-in tax liability could not be taken as a discount when there was no evidence that ADDIC planned to liquidate or sell its assets. The Court concluded that a \$9 million discount was properly included as a part of the lack of marketability discount to be applied in value in the two blocks of stock.

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

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

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

77 T.C.M. at 1396.

The Court concluded that since capital gains taxes would be incurred as Johnco's timber was cut and sold, recognition of the gain was certain to occur independently of any liquidation that a hypothetical willing buyer of decedent's Johnco stock "would take into account Johnco's built in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However the court limited the discount "an amount reflecting the rate at

which they [the capital gains taxes] will be recognized, measured as the net present value of the built in capital gains tax liability that will be incurred over time as timber is cut.” *Id.*

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

In *Estate of Dunn v. Comm’r*, 301 F.3d 339 (5th Cir. 2002), the Fifth Circuit applied a dollar-for-dollar discount for unrealized capital gains when determining the value of a 62.96% interest in a closely-held Texas corporation under an asset-based approach. At her death, Mrs. Dunn owned 62.96% of Dunn Equipment was family-owned and operated company in the business of renting heavy equipment to refinery and petrochemical businesses. Reversing the Tax Court, the Fifth Circuit held, as a matter of law, the \$7.1 million built-in capital gains tax liability of Dunn Equipment’s assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of Dunn Equipment.³ The Court opined that the very definition of the asset-based approach contemplates the consummation of the sale of the asset being valued, triggering the built-in capital gains tax. The holding makes rational sense, and should be applied in any asset-based valuation of a C corporation since the asset-based approach assumes that the buyer is paying for the stock of the entity based upon the price the buyer could realize for the assets of such entity. Before the buyer can realize such value, however, the corporate level capital gains tax must be incurred.

In *Estate of Jelke v. Comm’r*, the Eleventh Circuit adopted the Fifth Circuit’s dollar-for-dollar discount in *Dunn*.

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

B. Undivided Interests in Real Estate

The IRS has often asserted that the only discount which should be applied when determining the fair market value of undivided interests in real property are the costs and

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

expenses associated with a partition of that property. *See* PLR 9336002 (May 28, 1993). The Tax Court has consistently recognized, however, that IRS reliance on partition costs as the sole basis for the discount is misplaced.

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

In *Ludwick v. Comm’r*, T.C. Memo 2010-104 (May 10, 2010), the Tax Court determined the undivided interest discount for a 50 percent interest in a Hawaiian vacation home. In response to the Tax Court’s question of why the discount should be any greater than the costs of partition, the experts for both the taxpayer and the IRS agreed that adjustments beyond the cost of partition should be allowed for lack of marketability and illiquidity risks because of the inability to sell the house quickly at fair market value. Essentially rejecting the opinions of both experts, the Court determined the discount under a present value approach assuming (1) a two year partition action would be required (resulting in a 26.5 percent discount) and (2) the property could be sold in one year without a partition action (resulting in a 16.2 percent discount). The Court weighted those outcomes, concluding that there was a 90 percent likelihood that no partition action would be needed. This resulted in a discount of 17.2 percent. Given the Court’s short holding period, the principal reason for the 17.2 percent discount was the existence of operating expenses of \$350,000 per year. Had those operating expenses not been present, the discount would have been much lower. One factor that appears missing from the analysis is the general lack of marketability inherent in the interest. In other words, why would a buyer be interested in purchasing a property that they would simply turn around and sell in a partition action at a discount based on costs of partition and the time value of money?

C. Tiered Discounts

The IRS often takes the position that successive or tiered discounts should not be applied in determining the value of an interest in an entity which in turns owns an interest in another entity. But both the Tax Court and other courts have recognized the existence of “tiered discounts” when valuing an interest in a closely held entity. *See, e.g., Astleford v. Comm’r*, T.C. Memo 2008-128 (May 5, 2008) (court applied discounts of 30% and 36% in valuing limited partnership interest in partnership that owned a general partnership interest in real estate venture); *Gow v. Comm’r*, 79 T.C.M. (CCH) 1680 (2000) (court applied combined discounts for

lack of control and lack of marketability in valuing the stock of the top tier entity for 1989 and 1990, respectively, of 44% and 51%, and 41% in valuing the interest in the second tier entity); *Kosman v. Comm’r*, 71 T.C.M. (CCH) 2356 (1996); *Dean v. Comm’r*, 19 T.C.M. (CCH) 281 (1960); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954).

VII. PRIVILEGES IN THE ESTATE PLANNING CONTEXT

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

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

The typical knee-jerk reaction to a request for documents or correspondence (particularly documents in a lawyer’s file) is to assert all applicable privileges and refuse to produce the documents. However, the attorney-client privilege and the attorney work product privilege may not protect all contents in your file. More importantly, the production of carefully drafted estate planning correspondence or similar documents in response to such a request can actually help you state your case with the examiner or in litigation. With that goal in mind, as you are working on a client’s estate plan, assume that every document prepared by the estate planning lawyer, the client, the accountant, or any other person involved in the estate planning process may be reviewed by an IRS agent, appeals officer, district counsel, or ultimate finder of fact in tax litigation.

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

B. Understand the IRS’s Broad Subpoena Power

The IRS has broad subpoena powers that can be used to subpoena documents or compel testimony from a taxpayer, the taxpayer’s representative, or a third party. For the purpose of “ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue tax,” the IRS is

authorized (i) to examine any books, papers, records, or other data that may be relevant or material to such inquiry and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records, or other data. I.R.C. § 7602(a).

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

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

C. Understand and Preserve All Privileges

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

1. The Attorney-Client Privilege

a. What the Privilege Covers

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

WL 191869 (May 16, 1994) (“[T]he privilege would extend to . . . an accountant hired by the attorney to assist the attorney in understanding the client’s financial information.”).

A privileged communication is “any expression through which a privileged person . . . undertakes to convey information to another privileged person and any document or other record revealing such an expression.” *See, e.g.*, Restatement of the Law Governing Lawyers § 119 (Proposed Final Draft No. 1 1996). Documents protected by the privilege include those that consist of or reflect communications between the lawyer and the client, as well as the advice given to the client. Likewise, internal memoranda between attorneys in the same office representing the same client are covered by the attorney-client privilege. *Cedrone v. Unity Sav. Ass’n*, 103 F.R.D. 423, 429 (E.D. Pa. 1984) (“[I]t is inconceivable that an internal memorandum between attorneys in the same office concerning the representation of a client, utilizing confidential information provided by that client, could be anything but protected by the privilege.”); *New York Underwriters Ins. Co. v. Union Constr. Co.*, 285 F. Supp. 868, 869 (D. Kan. 1968) (holding that interoffice memorandum between lawyers and communications and consultations between attorneys representing same party were covered by attorney-client privilege). Even an attorney’s billing records, expense reports, and travel records that reveal particular areas of research or that reveal the nature of the services provided are protected under the privilege. *In Re: Grand Jury Witness*, 695 F.2d 359, 362 (9th Cir. 1982) (holding that bills, ledgers, statements, time records, and the like that reveal “the nature of the services provided” should be privileged).

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

b. What the Privilege Does Not Cover

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

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

In addition, advice rendered in connection with tax return preparation has been held not to be privileged. *See United States v. Frederick*, 182 F.3d 496, 500 (1999). The *Frederick* Court’s refusal to apply the attorney-client privilege in the context of return preparation is based on the theory that return preparation is “accountant’s work,” whether

performed by an accountant or a lawyer. For lawyers who prepare tax returns for clients, *Frederick* is a must read case.

c. Waiver

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

Moreover, under the doctrine of subject matter waiver, other communications related to the disclosed materials may lose their privileged status. Note that communications with accountants or other advisors, when made “to assist the attorney in rendering advice to the client,” are protected under the attorney-client privilege. *See, e.g., Adlman*, 68 F.3d at 1499; *Kovel*, 296 F.2d at 921-24 (holding that privilege may be properly invoked by accountant if communications were made pursuant to consultative role to attorney and at attorney’s direction); *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) (“Information provided to an accountant by a client at the behest of his attorney for the purposes of interpretation and analysis is privileged to the extent that it is imparted in connection with the legal representation.”); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (providing short form opinion did not constitute waiver of attorney work product privilege); *In re G-I Holdings Inc.*, 218 F.R.D. 428 (D. N.J. 2003) (privilege deemed waived by asserting reasonable cause defense on the basis of legal advice). As with other communications sought to be protected by the privilege, to invoke the privilege, the client must establish that the communication with the third party was made “in confidence for the purpose of obtaining legal advice.” *United States v. Gurtner*, 474 F.2d 297, 298 (9th Cir. 1973).

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

2. The Attorney Work Product Privilege

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

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

3. The Tax Practitioner’s Privilege

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

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

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

The district court for the District of Columbia has also issued several important decisions in the tax shelter litigation involving KPMG. In *United States v. KPMG*,

237 F. Supp. 2d 35 (D. D.C. 2002), citing *Frederick*, the court determined that the Section 7525 privilege did not extend to KPMG opinion letters issued to its client because such letters were prepared in connection of preparing a tax return. In a subsequent decision, the court determined that some of the documents KPMG claimed to be protected by Section 7525 were in fact so protected. *United States v. KPMG*, 2003-2 U.S.T.C. ¶150,691 (D. D.C. 2003). See also *United States v. BDO Siedman, LLP*, 225 F. Supp. 2d 918 (N.D. Ill. 2003), *aff'd*, 337 F.3d 802 (7th Cir. 2003) (name of clients not privileged under Section 7525); *Black & Decker Corp. v. United States*, 219 F.R.D. 87 (D. Md. 2003) (accounting firm's advice not privileged because such accounting firm's communications with company were not delivered to facilitate communications between company and its attorney).

4. The Physician-Patient Privilege

IRS requests for information increasingly seek access to medical records of a decedent and interviews with treating physicians. Under state law, a doctor-patient privilege often protects such information. However, where the IRS is seeking to enforce a summons issued under federal statutory authority, federal privilege rules generally apply. See, e.g., *United States v. Moore*, 970 F.2d 48, 50 (5th Cir. 1992). The Fifth Circuit has held that there is no physician-patient privilege under federal law. *Id.* No other circuit has adopted the privilege. The Supreme Court has not yet directly addressed the issue.

D. Put Your Client in a Position to Produce Correspondence or Documents in Your File if it Is in the Client's Best Interest to do so

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

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

E. Where Are We Now?

Recent opinions have dealt a significant blow to the lack of economic substance, lack of business purpose, I.R.C. § 2703, and gift on formation positions taken by the IRS in the family limited partnership area. Subject to the continuing development of case law and § 2036, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes. In fact, the § 2036 cases where the IRS has successfully disregarded the existence of an entity involve situations where the Tax Court has found that the partners have not respected and treated the partnership as a separate legal entity for state law purposes.

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

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

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

VIII. CHOICE OF FORUM IN A TRANSFER TAX DISPUTE

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

litigation. These forums are the United States Tax Court, the United States district courts, and the United States Court of Federal Claims.⁴

There are two types of litigation that the taxpayer can commence to determine the amount of a tax liability. The first type is “deficiency” litigation, which occurs in the Tax Court. In deficiency litigation, the IRS issues a statutory notice of deficiency identifying a proposed tax liability. The notice of deficiency serves as the jurisdictional prerequisite to proceed in the Tax Court,. The second type of litigation is “refund” litigation, which occurs in the United States district courts and in the United States Court of Federal Claims. Refund litigation is jurisdictionally premised on the payment of the full amount of the tax in dispute and the timely filing of a claim for refund with the IRS. Each of the three choices of forum for the transfer tax dispute has advantages and disadvantages.

A. Payment of the Tax?

The taxpayer does not have to pay the tax before proceeding in the Tax Court. Instead, the taxpayer has ninety days from date of the notice of deficiency to file a petition with the Tax Court in Washington, D.C. If the proposed deficiency is paid before the notice of deficiency is issued, the Tax Court will not have jurisdiction. If less than the entire proposed deficiency is paid before the notice of deficiency is issued, the notice of deficiency will be issued only for the balance of the deficiency.⁵ However, payment of the proposed deficiency after issuance of the notice of deficiency but before (or after) the filing of the petition will not deprive the Tax Court of jurisdiction.⁶

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

B. Finder of Fact

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

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

⁵ Rev. Proc. 63 11, 1963 1 CB 497.

⁶ I.R.C. § 6213(b)(4).

C. Legal Precedent

Before filing your case, determine whether the court or the court to where any appeal will be taken has unfavorable precedent. If, for example, the Claims Court has a case holding against your legal position but the Tax Court has a case holding in your favor, the Tax Court would likely be your forum of choice. An example of the importance of precedent in the transfer tax area is how a claim asserted against a decedent's estate is valued for estate tax deduction purposes. The Fifth Circuit has allowed a deduction based upon a "fair market value" of the claim as of the date of the decedent's death, and does not consider post-valuation date satisfaction of the claim.⁷ The Second Circuit, on the other hand, has only allowed the deduction only to the extent the claim was actually established and paid during estate administration.⁸

D. Discovery

Discovery is much more limited in the Tax Court.⁹ Fact depositions are limited and experts are almost never deposed. Discovery in the Claims Court and district court is similar to traditional civil litigation. If the taxpayer is concerned about discovery costs, the Tax Court is generally the preferred forum.

E. Location of Trial

Tax Court cases are generally tried in the city designated by the taxpayer.¹⁰ A list of cities in which regular sessions of the Tax Court are held is listed in the Tax Court Rules. If the taxpayer fails to designate a place of trial, the I.R.S. shall designate a place of trial preferred by the Commissioner.¹¹ Claims Court cases are often tried in Washington, D.C. District court cases must be filed and tried in the district where the taxpayer resides.

F. Appellate Venue

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

G. Opposing Counsel

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

⁷ See *Estate of Smith v. Comm'r*, 198 F.3d 515 (1999).

⁸ See *Comm'r v. Shively*, 276 F.2d 372 (2nd Cir. 1960).

⁹ See T.C.R. 70, 91.

¹⁰ T.C.R. 140.

¹¹ *Id.*

represented by Justice Department, Tax Division, Court of Federal Claims Section. In district court cases, the government is generally represented by Justice Department, Tax Division.

H. New Matters

In the Tax Court, the taxpayer has the burden of proof to show that the Commissioner's determination and adjustments were erroneous. Tax Court proceedings, however, toll the statute of limitations on the IRS's ability to assert an additional deficiency. Accordingly, the IRS can raise a new matter in a Tax Court proceeding and seek an increased deficiency from the taxpayer. The burden of proof will be on the Internal Revenue Service with respect to the increased deficiency.¹²

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

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

¹² T.C. R. 142 (a); *Ferguson v. Comm'r*, 47 T.C. 11 (1966).

Exhibit A

Internal Revenue Service

Department of the Treasury

Date:

In Reply Refer to:

Person to Contact:

Contact Telephone Number:

Fax Number:

Re:

Dear

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

1. Copies of donor's Federal Income Tax Returns (1040) for the year before, the year of and the year after the gift referenced above.
2. Copies of all 709's filed with with appraisals, acts of donation and other supporting documentation. This includes 709's filed by your spouse.
3. If any assets subject to any of the above referenced gifts have been sold or agreements to sell have been entered into subsequent to date of donation please provide complete details, including contracts, deeds and closing statements.
4. A list of donations of any kind, other than customay holiday and birthday gifts of small value, made during your life time regardless of whether a Gift Tax Return Form 709 was filed.
5. If the object of any of the above donations was an interest in any closely held corporation, partnership, limited liability company or other business organization, we need the following:
 - a) All documents relating to the creation of the entity (including bills) from any attorney, accountant or firm involved in recommending the creation of the entity or in drafting the necessary documents. If a claim is made that any of these documents are privileged, identify each privileged document by date, source, audience, and reason for the privilege.
 - b) Articles of organization and operating agreement, with any amendments.
 - c) All documents that were prepared to meet state law requirements on the formation and operation of the entity.
 - d) All financial statements and tax returns prepared and/or filed since inception.
 - e) All of the entities' bank and other records (i.e., general ledger, cash receipts and disbursements journals, check registers, etc.) which reflect the amount and nature of all deposits and distributions, including distributions to owner/members, for the period since the entity was formed to the current period.
 - f) Minutes of all meetings; if none, indicate the dates of all meetings and the business discussed.
 - g) Evidence showing how the value of each entity asset was arrived at as of the date:
 1. it was contributed to the entity;

2. of each gift of a interest in the entity;
provide all appraisals and supporting workpapers.
- h) Evidence as to how the entity was valued as a whole as well as fractional interest. Provide all appraisals if not already furnished.
 - i) Evidence to substantiate all initial and subsequent capital contributions and the source of all contributions by owners other than the donor.
 - j) For any entity asset that has been sold or offered for sale since the formation of the entity, provide evidence which documents the sale or attempted sale (i.e., sales agreement, listing agreement, etc.).
 - k) For each entity asset, explain/provide:
 - 1. evidence that the entity owns the asset;
 - 2. when the donor acquired the asset;
 - 3. how the asset was used by the donor since its acquisition and how the entity has used the asset since; and
 - 4. who managed the asset prior to and after its contribution, explain in detail what management consisted of and how it changed after the entity was formed.
 - l) Brokerage statements reflecting the ownership and activity of the securities and mutual funds contributed to the entity for the period beginning one year prior to the formation of the entity and continuing through the current date, and copies of any other tax returns and financial statements which reflect the activity of the entity's assets, if different from the foregoing.
 - m) For each gift or transfer of an interest, provide:
 - 1. evidence that the interest was legally transferred under state law and under the terms of any agreement among the owner/members.
 - 2. any assignment of any interest along with the terms of the assignment;
 - 3. the amount and source of any consideration paid along with an explanation as to how the amount was arrived at.
 - n) Provide the following with respect to the donor, all other original members and any recipients of gifts or transfers of interests:
 - 1. date of birth;
 - 2. education and occupation;
 - 3. experience and expertise in dealing with real estate, financial affairs and investments;
 - 4. extent of the donor's investments as of the date of the formation of the entity, including a summary of assets that were not contributed to the entity; provide tangible evidence thereof; and
 - 5. any personal financial statements and credit applications which were prepared in connection with loan applications after the LLC was created.
 - o) Indicate whether the entity is currently in existence, and, if so, provide the current ownership interests.
 - p) Provide a summary of any other transfers of business interests not reflected in the gift tax returns filed.
 - q) A statement describing the donor's state of health at the time of the formation of the entity and for the six month period prior thereto, including a description of any serious illnesses. Please also provide the names, addresses and telephone numbers of all doctors who would have knowledge of the donor's state of health during this period to the present date and provide these doctors with authorization to respond to the Service's future

- requests for information, including a copy of the medical records, in necessary.
- r) A copy of the Donor's will, revocable trust, and any executed power of attorney, if not submitted with the return.
 - s) A statement indicating the identity of the parties recommending the use of the LLC or partnership, when the recommendations were made, and the reasons set forth in support of using such an entity.
 - t) Names, addresses, and current telephone numbers of the representatives of the Donor/Estate, all donees/beneficiaries, all partners or members, accountants/bookkeepers, and brokers/investment advisors.

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

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

Very truly yours,

Enclosures:
IRS Publication 1
Form 2848 Power of Attorney