TRANSFERRING WEALTH: *HOLMAN V. COMMISSIONER OF INTERNAL REVENUE* RETAINS HOPE FOR THE FAMILY LIMITED PARTNERSHIP DESPITE CONTINUOUS ATTACKS BY THE IRS

I. INTRODUCTION

Suppose Rob, a wealthy widower, owns 100,000 shares of stock in company X worth $1,000,000 and has only one descendant (age 10). Realizing his tremendous wealth, he wants to gift a majority of the stock to his child to ensure the child's financial well-being should he meet an untimely death. Additionally, Rob wants to reduce the federal taxes levied on this gift. Rob's attorney informs him that he may be able to reduce his tax liability by placing the stock in a Family Limited Partnership ("FLP") before making the gift. Consequently, Rob forms the FLP, and within one week transfers a 75% limited partnership interest to his child. This strategy results in significant gift tax savings.[1]

Should Rob be allowed to minimize his gift tax liability through the establishment of a FLP? Or, should the FLP be recognized strictly as a vehicle to transfer wealth, resulting in no tax reductions? The court in *Holman v. Commissioner of Internal Revenue* addressed this dilemma.

This Note focuses on the *Holman* court's discussion of acceptable methods to utilize an FLP to provide tax savings for gift transfers through application of valuation discounts. Part II discusses the factual background of *Holman*. Part III explains the legal and jurisprudential framework of the FLP, including previous attempts by the Internal Revenue Service ("IRS") to reduce FLP benefits. Part IV gives a detailed explanation of the *Holman* court's opinion and reasoning. Lastly, Part V analyzes the possible effects of the *Holman* decision on the FLP's ability to remain a valuable estate and gift tax planning entity.

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1. Gift transfers from an FLP may result in tax savings due to the availability of discounts; see *infra* text accompanying notes 37-43.

II. FACTS AND HOLDING

A. THE HOLMAN FAMILY PARTNERSHIP

On November 2, 1999, after consulting an attorney, petitioner taxpayers Thomas and Kim Holman formed an FLP and transferred a substantial amount of Dell stock to the partnership.[2] As a result, the Holmans received partnership interests in proportion to their contributions, thus becoming general (0.89% each) and limited partners (98.08% combined).[3]

The Holmans' reasons for creating the partnership were "long-term growth, asset preservation, asset protection, and education."[4] More specifically, they intended the partnership to accomplish the following:

> (1) maintain control of Family Assets; . . . (3) increase Family wealth; (4) establish a method by which gifts can be made without fractionalizing Family Assets; (5) continue the ownership of Family Assets and restrict the right of non-Family persons to acquire interests in Family Assets; . . . and (9) promote the Family's knowledge of and communication about Family Assets.[5]

The primary incentive for formation of the FLP, however, was to preserve family wealth.[6] Preservation of the family wealth encouraged the Holmans to include commonly used transfer restrictions in the partnership agreement (hereinafter the "Holman Agreement").[7] Specifically, the

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2. Holman v. Comm'r, 130 T.C. No. 12, *3 (West 2008). The Holmans contributed 35,000 shares of Dell stock each. *Id.* In addition, an appointed trustee/custodian for the Holmans' children contributed 100 shares of Dell stock. *Id.* The Holmans' attorney advised them that the ability to make gifts of partnership interests (instead of stock) through use of an FLP would result in gift tax savings due to the application of valuation discounts. *Id.* at *2.

3. *Id.* at *3. The trustee/custodian also received a 0.14% limited partnership interest for her contribution to the FLP; this amount was equivalent to her financial contribution. *Id.*

4. Holman v. Comm'r, 130 T.C. No. 12, *2 (West 2008). The Holmans stated their reasons for creating the FLP; however, there was some doubt as to whether the partnership was created for the stated purposes. *Id.*

5. *Id.* at *4. Reasons 2, 6, 7, and 8 are omitted because they are irrelevant for the purposes of this Note.

6. *Id.* at *3. "Remember, the big goal of this thing is to preserve the assets and to disincentivize [sic] the girls from getting rid of these assets, spending these assets, feeling entitled to these assets." *Id.* Despite the immediate plans for the partnership to hold the Dell stock, the Holmans lacked long-term direction for the FLP: the partnership lacked a business plan and telephone listing, its assets consisted solely of Dell stock, and no income tax returns or financial statements were prepared because the FLP failed to produce income. *Id.* at *8.

7. Holman v. Comm'r, 130 T.C. No. 12, *4-5 (West 2008); *see* Troy Renkemeyer, Comment, *The Family Limited Partnership: An Effective Estate Planning Tool*, 64 UMKC L. REV. 587, 589-90 (1996) (stating that transfer restrictions and buy-sell agreements are often used to prevent involuntary transfers).

agreement forbade the limited partners from transferring partnership interests without the consent of all partners, unless the transfers went to certain family members.[8] Additionally, if prohibited transfers were deemed effective, the FLP would have the opportunity to purchase the assignments at fair market value after discounts.[9]

B. THE GIFTS

Six days after the initial contribution of stock, the Holmans began making substantial transfers of partnership interest in the FLP for the benefit of their four children.[10] On November 8, 1999, they transferred a 70.20% limited partnership ("LP") interest to a trust established for their children and a 14.26% LP interest to a custodian for one of their children.[11] They made an additional transfer the following month to three custodial accounts maintained for the remaining daughters; this transfer equalized the custodial accounts of the four children to a 10.01% LP interest for each child.[12]

For federal gift tax valuation purposes, the Holmans applied a discount of 49.25% to each of the gifts of LP interests.[13] The discounts were taken due to the "lack of marketability" and "minority interest status" of the partnership interests.[14] As a result of the valuation discounts applied, respondent—Commissioner of Internal Revenue Service ("IRS")—alleged that the direct gifts of partnership interests should have been treated as indirect gifts of Dell stock pursuant to the Internal Revenue Code ("I.R.C.") § 2511, or in the alternative, as indirect gifts of stock under the "step transaction doctrine."[15] Thus, the IRS issued tax deficiencies for 1999,

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8. *Holman*, 130 T.C. No. 12 at *4 (citing paragraphs 9.1 and 9.2 of the Holman Agreement).

9. Holman v. Comm'r, 130 T.C. No. 12, *5 (West 2008) (citing paragraph 9.3 of the Holman Agreement). An unacceptable or prohibited transfer was any transfer "prohibited or rendered void by the terms" of the Holman Agreement. *Id.* at *5.

10. *Id.* at *6.

11. *Id.*

12. *Id.* The Holmans made subsequent gifts about two months later and once again approximately a year after that. *Id.* at *7.

13. Holman v. Comm'r, 130 T.C. No. 12, *7 (West 2008). The Holmans filed timely gift tax returns for 1999, 2000, and 2001 each to which they applied a valuation discount of 49.25%. *Id.* at *6-7. Therefore, they reported the fair market value of the 1999, 2000, and 2001 gift transfers as follows: $1,203,654; $80,000; and $80,000. *Id.* These amounts were the taxable bases (the amount to which the tax is applied) used by the Holmans when filing their gift tax returns. *Id.*

14. *Id.* at *9; *see infra* text accompanying notes 37-43.

15. Holman v. Comm'r, 130 T.C. No. 12, *10 (West 2008). I.R.C. § 2511 provides that the federal gift tax will be applied to transfers of property by gift whether "direct or indirect." I.R.C. § 2511 (2008). The "step transaction doctrine" is a doctrine which allows a combination of separate steps to be viewed as a single transaction when the steps are "integrated, interdependent, and focused toward a particular result." *Holman*, 130 T.C. No. 12 at *11 (quoting Penrod v.

2000, and 2001 for the following amounts: $205,473; $8,793; and $16,009.[16] These deficiencies developed due to the differences in the respective parties' fair market valuations of the gifts.[17]

Additionally, the IRS relied on I.R.C. § 2703 to assert that the Holmans should have valued the gift transfers without considering the restrictions placed on the right to use or sell the LP interests.[18] Thus, the IRS argued that the Holmans abused their application of valuation discounts.[19]

The United States Tax Court held that "[t]he 1999 gift [was] properly treated as a direct gift of LP [interests] and not as an indirect gift of Dell shares."[20] However, the court also held that paragraph 9.3 of the Holman Agreement failed to fulfill two of the three tests of I.R.C. § 2703(b) and as such, the paragraph should have been disregarded for valuation purposes.[21] As a result, the court determined that the discounts taken due to lack of control and marketability of the LP interest should have been reduced to a proper amount, and the court revalued the gifts.[22]

Comm'r, 88 T.C. 1415, 1428 (1987)). *See also infra* text accompanying notes 64-81.

16. *Holman*, 130 T.C. No. 12 at *1. If the IRS determines that a taxpayer has paid an insufficient amount of gift tax, the law authorizes the IRS "to send notice of such deficiency to the taxpayer by certified or registered mail." INTERNAL REVENUE SERV., EXTENDING THE TAX ASSESSMENT PERIOD 3 (2007), *available at* http://www.irs.gov/pub/irs-pdf/p1035.pdf.

17. The IRS's determined values (after reversal of the discounts) for the 1999, 2000, and 2001 gifts were $2,369,368; $157,824; and $157,520 respectively. Holman v. Comm'r, 130 T.C. No. 12, *8 (West 2008). On the other hand, the Holmans reported the gifts (after a 49.25% discount) at values of $1,203,654; $80,000; and $80,000 respectively. *Id.* at *6-7. For example, assume the fair market value (without discounts) of a gift is $2,000,000; applying a discount of 49.25% would result in a taxable base of $1,015,000. Applying the appropriate gift tax bracket to these figures, the $2,000,000 gift would bear taxes of $780,000 (assuming no annual/lifetime exclusions). *See* INTERNAL REVENUE SERV., INSTRUCTIONS FOR FORM 709 (2008), *available at* http://www.irs.gov/pub/irs-pdf/i709.pdf. On the other hand, the discounted gift of $1,015,000 would result in taxes of $351,950 (assuming no annual/lifetime exclusion) [$345,800 + ($1,015,000-$1,000,000)(0.41)]. *Id.* Thus, applying a discount of 49.25% to the gift would result in a net tax savings of $428,050 ($780,000-$351,950). The annual exclusion credit and the lifetime exclusion credit are ignored for the purposes of this Note.

18. Holman v. Comm'r, 130 T.C. No. 12, *8 (West 2008). Section 2703(a) of the Internal Revenue Code provides that, in general, gift transfers should be valued without regard to "restriction[s] on the right to sell or use the [property]." I.R.C. § 2703(a) (2008).

19. *Holman*, 130 T.C. No. 12 at *14.

20. *Id.* The court determined that the gifts were direct gifts of LP interests under the *Shepherd* rule and under the step transaction doctrine. *Id.* at *11, *14.

21. Holman v. Comm'r, 130 T.C. No. 12, *14 (West 2008).

22. *Id.* at *24, *28. This Note restricts its discussion to the effects of I.R.C. § 2703 (2008) on the amount of valuation discounts and does not include discussion of the other factors contributing to a reduction or addition of the valuation discounts.

III. BACKGROUND

A. FAMILY LIMITED PARTNERSHIP

A limited partnership is comprised of both limited partners and general partners.[23] Unlike the general partners, the limited partners are not responsible for partnership liabilities beyond the amount of their investment."[24] Additionally, limited partners generally have "limited rights" and are not allowed to participate in management decisions of the partnership.[25] An FLP is simply "a limited partnership in which members of a family hold all or substantially all of the interests."[26]

Traditionally, FLPs have been created by wealthy individuals with the objective of shifting family wealth to their descendants.[27] When properly structured and operated, an FLP can minimize tax liability, protect assets, and transfer wealth.[28]

The FLP consists of at least one general partnership interest and at least one limited partnership interest, just as a traditional limited partnership.[29] The general partners (usually parents or grandparents) are required to hold at least a one percent interest in the FLP and are able to retain management rights, while the limited partner's role is restricted.[30] Regardless of a partner's status, each partner is generally entitled to the capital and income of the FLP in proportion to his/her partnership interest.[31] Although the FLP prevents limited partners from making decisions, it grants them the benefit of a liability shield; whereas, it provides no such liability protection for the general partner.[32]

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23. Renkemeyer, *supra* note 7, at 587-88. The laws for limited partnership formation may vary from state to state. *Id.* at 610.

24. *Id.* at 589. However, "[s]ome planning can be done to limit the general partners' exposure to liability as well, such as the use of a corporation to act as the general partner (which offers complete limited liability)." *Id.*

25. *Id.* at 589, 610.

26. Katherine D. Black et al., *When a Discount Isn't a Bargain: Debunking the Myths Behind Family Limited Partnerships*, 32 U. MEM. L. REV. 245, 249 (2002); *see also* Leslie A. Droubay, Comment, *The Certainty of Death and Taxes for Family Limited Partnerships*, 7 J. SMALL & EMERGING BUS. L. 523, 525 (2003).

27. Robert B. Labe, *Business Problems & Planning: Business Succession Planning*, 75 MICH. B.J. 940, 945 (1996).

28. Renkemeyer, *supra* note 7, at 587.

29. *Id.* at 587-88.

30. *Id.* at 588. General partners make investment decisions. *Id.*

31. *Id.*

32. Renkemeyer, *supra* note 7, at 610-11. Once a limited partner transfers assets to the FLP, the assets are no longer personal assets and therefore are generally not subject to claims from the contributing partner's personal creditor. *Id.* at 589. Thus, the FLP can be an important tool for

In a typical FLP, the parents/grandparents will contribute the initial assets and receive a general interest and limited partnership interests in accordance with their input.[33] After the initial funding, the parents/grandparents will transfer limited partnership interests to their children/grandchildren.[34] Instead of making a direct gift at the value of the underlying assets, the parent/grandparent makes a gift of partnership interests at a discounted rate.[35] Thus, the FLP allows a reduction in transfer taxes while generally permitting the parent/grandparent to retain control of the underlying assets.[36]

One of the most significant tax advantages of an FLP is the valuation discounts which are potentially available for gifts of limited partnership interests to family members.[37] Valuation discounts are applied to transfers of limited partnership interests to reflect the restrictions of the entity, which limit the partnership interests' value.[38] The most common discounts the law allows for FLPs are the lack-of-marketability and lack-of-control ("minority interest") discounts.[39]

The minority interest discount is applied to transfers of limited partnership interests to reflect the management and operational rights that a limited partner does not have.[40] The lack-of-marketability discount

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protecting assets. *Id.*

33. *See* Renkemeyer, *supra* note 7, at 588-89.. The parents will typically hold a small general interest (gives management control) and receive a limited interest in proportion to their capital contributions. *Id.*

34. *Id.* This transfer of limited interests allows the parents to retain control over management affairs while, at the same time, giving interests in the capital to the children. *Id.*

35. *Id.* at 589. The partnership interests are valued at a reduced amount due to lack of marketability and minority discounts. *Id.* at 599-600; *see infra* text accompanying notes 37-43.

36. Labe, *supra* note 27, at 945. The parents/grandparents are the only individuals with general partnership interests; thus, they retain all management and operational rights of the FLP. Renkemeyer, *supra* note 7, at 588-89.

37. Droubay, *supra* note 26, at 525.

38. *See* Renkemeyer, *supra* note 7, at 601, 606 (explaining that restrictions in the partnership agreement can provide valuation discounts); *see also* Andrea B. Short, *"Adequate and Full" Uncertainty: Courts' Application of Section 2036(a)(1) of the Internal Revenue Code to Family Limited Partnerships*, 84 N.C. L. REV. 694, 697 (2006) (explaining that limited interests are valued at the amount a hypothetical buyer would pay for them).

39. Martin A. Goldberg & Cynthia M. Kruth, *New Life for Valuation Discounts in Family Entities*, 16 QUINNIPIAC. PROB. L.J. 48, 49 (2002). Other discounts may be available, such as the "portfolio discount"—justified by the idea that, to obtain wanted assets, a buyer must sometimes accept unwanted assets with the purchase. *Id.*

40. *Id.* A potential buyer of limited interests would have no say in the partnership's investment strategy and would lack the ability to recover his or her investment by forcing liquidation. Holman v. Comm'r, 130 T.C. No. 12, *21 (West 2008). Due to a lack of control, the limited partnership interests are valued at a lower rate than the value of the assets they represent. Short, *supra* note 38, at 694, 697.

recognizes a third-party buyer's potential unwillingness to purchase an interest in a "non-publicly traded entity."[41] The application of these discounts permit gifts of partnership interests to be transferred at values below the fair market value of the underlying property.[42] When a controversy exists as to the applicable valuation discounts available, introduction of expert testimony aids in ascertaining the appropriate amount.[43]

B. FEDERAL GIFT TAX APPLICATION TO TRANSFERS OF PARTNERSHIP INTEREST

The Internal Revenue Code imposes a tax on property transferred by gift; therefore, transfers of partnership interests are generally subject to the federal gift tax.[44] The federal gift tax was developed to uniformly tax the transfer of property during an individual's lifetime.[45] The taxable gift amount is determined by measuring the extent to which the value of the property transferred surpasses the consideration given in return,[46] except to

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41. Leslie Bounds, Note, *Family Limited Partnerships: The Parts Can be Worth Less Than the Whole* Lappo v. Commissioner, 24 MISS. C. L. REV. 49, 53 (2004). Additionally, the partnership agreement may contain restrictions which limit the potential buyers' ability to transfer their interests. *See* Renkemeyer, *supra* note 7, at 601, 606.

42. Droubay, *supra* note 26, at 525. To better understand the complex taxation issues presented by valuation discounts in FLPs, consider the following transaction. Suppose parent A forms an FLP and contributes 10 shares of company stock, which have a combined value of $100,000, to the partnership. In return for his contribution of the 10 shares, A receives a 1% general partnership interest and a 99% limited partnership interest. Additionally, presume that the partnership agreement contains restrictions which limit the transferability of the partnership interests. Suppose further that A transfers a 10% limited partnership interest (roughly one share) to child B. For gift tax purposes, instead of valuing the transfer of interest at $10,000, it would likely be valued at approximately $7,000 to reflect the fact that a hypothetical buyer of the interest/share would not have control of the entity and the share would not be readily marketable. Thus, the share was discounted at 30% due to lack of control and marketability. Instead of paying the gift tax on the $10,000, A is able to pay tax on the $7,000 value; however, B now owns the entire $10,000 value.

43. Bounds, *supra* note 41, at 60.

44. I.R.C. § 2501 (2008); 26 C.F.R. § 25.2511-1(h)(1) (2008). *See also* Shepherd v. Comm'r, 115 T.C. 376, 389 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (applying the principle of 26 C.F.R. § 25.2511-1(h)(1) (2002) to a limited partnership). Transfers of limited partnership interests are subject to the gift tax unless full and adequate consideration is given in exchange for the interests. I.R.C. § 2512(b) (2008).

45. Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making it Enforceable*, 87 B.U. L. REV. 759, 761-64 (2007).

46. I.R.C. § 2512(b) (2008). Transfers of property for insufficient consideration, regardless of the means employed, are subject to the federal gift tax. *Id.* To avoid taxation on the transfer of property, a transferor should receive full compensation for the value of the property. *Id.* The individual making the transfer does not need donative intent; insufficient compensation is enough to trigger the tax. 26 C.F.R. § 25.2511-1(g)(1) (2008). For example, suppose A—a shareholder in B Corporation—transfers $100,000 worth of assets to B Corporation without receiving any

the extent that the transfer is in the ordinary course of business and free from donative intent.[47]

The tax is applied to transfers pursuant to 26 C.F.R. § 25.2511-1 regardless of whether the gift is direct or indirect.[48] In effect, the transfer of assets to an FLP for less than adequate consideration constitutes an indirect gift from the contributing partner to the remaining partners.[49]

For gift tax purposes, the value of the property transferred is generally the fair market value of the property.[50] Fair market value has been defined as "the price at which 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."[51] Both the buyer and seller are presumed to seek a maximum economic advantage from the exchange.[52] The net asset value approach is often applied to help determine the fair market value of limited partnership interests.[53] This method considers three aspects: "(1) the net asset value of the partnership, (2) the applicable control discount, and (3) the applicable lack of marketability discount."[54]

It is well established that the federal gift tax is applicable to transfers of property between partners for less than adequate compensation.[55] The controversial issue, however, is the proper valuation of the property transfers.[56]

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compensation in return. The $100,000 transfer would generally represent a gift by A to the other individual shareholders of B Corporation "to the extent of their proportionate interests in the corporation." 26 C.F.R. § 25.2511-1(h)(1) (2008). Exceptions may apply in cases "such as . . . transfer[s] . . . to charit[y], [etc.]." *Id.*

47. 26 C.F.R. § 25.2511-1(g)(1) (2008).

48. *Id.* § 25.2511-1(a). Any transaction involving a gratuitous transfer of property interest is considered to be a gift. *Id.* § 25.2511-1(c)(1).

49. *See id.* § 25.2511-1(h)(1).

50. *Id.* § 25.2512-1. However, special valuation rules apply in certain circumstances. *See* I.R.C. §§ 2701-2704 (2008).

51. 26 C.F.R. § 25.2512-1 (2008); *see also* Shepherd v. Comm'r, 115 T.C. 376, 383 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (quoting United States v. Cartwright, 411 U.S. 546, 551 (1973)).

52. Estate of Newhouse v. Comm'r, 94 T.C. 193, 218 (1990) (citing Estate of Curry v. United States, 658 F.2d 999, 1006 (5th Cir. 1981)).

53. *See, e.g.*, Estate of Dailey v. Comm'r, 84 T.C.M. (CCH) 633, *5 (West 2002).

54. Brief of Petitioner at 36, Holman v. Comm'r, 130 T.C. No. 12 (West 2008); *see also Estate of Dailey*, 84 T.C.M. (CCH) at *5.

55. *See* 26 C.F.R. § 25.2511-1(h)(1) (2008).

56. *See* Bounds, *supra* note 41, at 54 (suggesting that a transfer of property to an FLP raises the question of whether the gift is one of partnership interests or of underlying assets).

C. THE IRS'S PUSH TO RID FLPS OF GIFT TAX ADVANTAGES

The FLP's reputation as a tax-saving entity has brought an onslaught of attacks by the IRS to minimize these savings.[57] This Note focuses on two theories implemented by the IRS in an attempt to minimize tax savings of the FLP: (1) valuing transfers of property as indirect gifts of underlying assets (rather than partnership interests), and (2) reducing valuation discounts pursuant to I.R.C. § 2703.

1. ATTEMPTS BY THE IRS TO VALUE GIFTS AS INDIRECT GIFTS OF PROPERTY

Valuing transfers of property as gifts of underlying assets divests taxpayers of a right to claim substantial valuation discounts, thus resulting in greater gift taxes.[58] The IRS has implemented two theories in an attempt to value gift transfers at the fair market value of the underlying assets (ignoring discounts): 1) the *Shepherd* rule, and 2) the step transaction doctrine.[59]

a. Under the *Shepherd* Rule

In the past ten years, the IRS has made successful attempts to value gift transfers in an FLP as indirect gifts of underlying property rather than gifts of partnership interests.[60] The IRS has successfully accomplished these valuations as indirect gifts of property when the partnership interests are allocated prior to or simultaneous with the property contribution, partnership formation, or funding of the FLP.[61]

In *Shepherd v. Commissioner of Internal Revenue*, the taxpayer made

57. *See* Short, *supra* note 38, at 704-10 (listing attacks such as: economic substance arguments, special valuation arguments, and gift on formation arguments); *see also* Droubay, *supra* note 26, at 526-28; Estate of Jones v. Comm'r, 116 T.C. 121, 128, 130 (2001) (rejecting the IRS's § 2704 argument); Shepherd v. Comm'r, 115 T.C. 376, 385-86 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002) (reflecting a successful attempt by the IRS to consider the gifts as transfers of underlying assets rather than partnership interests); Estate of Strangi v. Comm'r, 115 T.C. 478, 484 (2000), *aff'd in part*, Gulig v. Comm'r, 293 F.3d 279 (5th Cir. 2002) (finding that the substance of the partnership was sufficient for tax purposes).

58. *See* Renkemeyer, *supra* note 7, at 599-600. The gifts would be valued at the fair market value of the assets rather than the fair market value of the partnership interests (with discounts). *Id.*

59. *See* Shepherd v. Comm'r, 115 T.C. 376, 385-86 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); *see also* Senda v. Comm'r, 433 F.3d 1044, 1046-48 (8th Cir. 2006), *aff'g* 88 T.C.M. (CCH) 8 (West 2004).

60. *Shepherd*, 115 T.C. at 385-86; *Senda*, 88 T.C.M. (CCH) at 1046-48.

61. *See Shepherd*, 115 T.C. at 389-90 (finding that the partnership interests were gifted before the funding); *Senda*, 88 T.C.M. (CCH) at 1046 (finding no evidence to establish that the partnership was funded before the interests were transferred).

a contribution of real property and stock to the newly formed FLP in which he was a 50% owner and his two sons were each 25% owners.[62] Rather than allocating the contributions to the supplying partner's account, the agreement stated that all contributions would be distributed on a pro rata basis to the capital accounts of each partner with respect to his ownership interests.[63] The court held that the transfers were indirect gifts of property and stock because the partnership interests were transferred to the children prior to the funding of the partnership.[64]

b. Under the Step Transaction Theory

Additionally, the IRS has attempted to value FLP gift transfers as indirect gifts of assets (rather than partnership interests) through application of the "step transaction doctrine."[65] The basic principle of the step transaction doctrine is that the substance of a transaction should triumph over its form.[66] Under this approach, a series of separate steps are viewed as "a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result."[67] In essence, when a unified series of steps is intended to achieve a particular result, the steps should not be treated individually, but instead as part of an "integrated whole."[68]

Three alternative tests have been developed to determine when the step transaction doctrine should apply: the "binding commitment" test, the "interdependence" test, and the "end result" test.[69] When considering the three tests in relation to the FLP, the steps which the IRS typically attempts to consider as an integrated whole are the creation, funding, and transfer of interests in the FLP.[70]

Each of the three tests utilizes a different approach to determine if the

62. Shepherd v. Comm'r, 115 T.C. 376, 380 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

63. *Id.*

64. *Id.* at 385. The court stated, "[n]ot 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 his contribution, thus entitling him to recoup the same amount upon liquidation of the partnership." *Id.* at 389. The court reasoned, however, that the father's contributions were partially reflected in the capital accounts of the noncontributing sons. *Id.*

65. *See* Senda v. Comm'r, 433 F.3d 1044, 1047-48 (8th Cir. 2006); *see also* Daniels v. Comm'r, 68 T.C.M. (CCH) 1310, *23-26 (West 1994).

66. *Daniels*, 68 T.C.M. (CCH) at *24.

67. Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987), *cited in* Holman v. Comm'r, 130 T.C. No. 12, *11 (West 2008).

68. Packard v. Comm'r, 85 T.C. 397, 420 (1985), *cited in Holman*, 130 T.C. No. 12 at *11.

69. Santa Monica Pictures, L.L.C. v. Comm'r, 89 T.C.M. (CCH) 1157, *291 (West 2005).

70. *See* I.R.S. Tech. Adv. Mem. 98-42-003, *29-30 (July 2, 1998).

separate steps should be treated as a single transaction.[71] The "end result" test invokes the step transaction doctrine when "it appears that a series of separate transactions is made up of prearranged parts of a single transaction, cast from the outset to achieve the ultimate result."[72] The "interdependence" test invokes the step transaction doctrine if the independent steps of a transaction are useless without completion of the whole series.[73] The "binding commitment" test invokes the step transaction doctrine if, once the first step of the transaction takes place, there is a binding commitment to follow through with the entire transaction.[74] The sequence in which the events occur is irrelevant so long as the steps are "clearly part of an overall plan."[75]

In *Senda v. Commissioner of Internal Revenue*, the court expanded the *Shepherd* rule by concluding that "integrated" transactions of funding an FLP and making gift transfers were indirect gifts of stock rather than gifts of partnership interests.[76] In *Senda*, the petitioners transferred shares of stock to their children through their FLP in exchange for purported accounts receivables; however, the petitioners failed to maintain adequate records, file timely tax returns, or prepare certificates of ownership.[77] Thus, there existed insufficient evidence as to whether the partnership interests were transferred to the children before or after the contribution of stock, and the court concluded that "[a]t best, the transactions were integrated . . . and, in effect, simultaneous."[78]

On appeal, the United States Eighth Circuit Court of Appeals strengthened the lower court's reasoning by applying the step transaction doctrine to the gifts made by the petitioners.[79] The court stated that in certain situations it may be proper to consider "distinct steps" as part of an "integrated whole, rather than in isolation," to present a more practical view

71. *Santa Monica*, 89 T.C.M. (CCH) at *291-92; *see also* Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 198 (1989), *cited in* Holman v. Comm'r, 130 T.C. No. 12, *11 (West 2008).

72. *Santa Monica*, 88 T.C.M. (CCH) at *292.

73. *Id.*

74. Cal-Maine Foods, Inc. v. Comm'r, 93 T.C. 181, 198 (1989).

75. Rev. Rul. 75-447, 1975-2 C.B. 113.

76. Senda v. Comm'r, 88 T.C.M. (CCH) 8, *16-17 (West 2004).

77. *Id.* at *4, *15-16. The children allegedly made contributions of oral accounts receivable in exchange for the partnership interests received; however, these contributions were never properly recorded. *Id.* at *4. Additionally, a fax seeking advice regarding the gift transfers was dated two days after the alleged transfer date. *Id.* at *17.

78. *Id.* at *16.

79. Senda v. Comm'r, 433 F.3d 1044, 1048 (8th Cir. 2006). The lower court realized that the transactions were likely integrated but failed to apply the step transaction doctrine directly. Senda v. Comm'r, 88 T.C.M. (CCH) 8, *16-17 (West 2004).

of the complete transaction.[80] The court further noted that "[t]he tax court recognize[d] that even if the Sendas' contribution would have first been credited to their accounts, this formal extra step does not matter."[81] Both courts ultimately held that the transfers were indirect gifts of stock rather than gifts of partnership interests.[82]

Accordingly, it can be inferred that gifts of property transferred prior to or simultaneous with the formation/funding of the FLP will likely be treated as indirect gifts of the underlying assets. However, it remains unclear how far the tax courts are willing to extend the reaches of the step transaction doctrine.

2. ATTEMPTS BY THE IRS TO MINIMIZE VALUATION DISCOUNTS BY DISREGARDING TRANSFER RESTRICTIONS PURSUANT TO I.R.C. § 2703

The gift tax will generally apply to gifts of property in an FLP; however, it is unclear to what extent the gifts will be eligible for a discount.[83] Because assets in an FLP are not easily liquidated, limited partnership interests are generally not worth their fair market value; therefore, discounts may be applied.[84]

The IRS, however, is constantly looking for ways to reduce the amount of valuation discounts applicable to transfers of LP interests.[85] In addition to the IRS's previous attempts to disregard valuation discounts by treating gifts of LP interests as gifts of the underlying assets, the IRS has also tried to reduce these discounts by challenging the validity of an FLP's stipulated transfer restrictions pursuant to I.R.C. § 2703.[86] Section 2703 states in pertinent part:

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80. *Senda*, 433 F.3d at 1048.

81. *Id.*

82. *Senda*, 88 T.C.M. (CCH) at *17; *Senda*, 433 F.3d at 1048-49.

83. *See* 26 C.F.R. § 25.2511-1(h)(1) (2008). Valuation discounts are applied on a case by case basis. *See, e.g.*, Estate of Strangi v. Comm'r, 115 T.C. 478, 491 (2000) (allowing a 31% discount); Church v. United States, No. SA-97-CA-0774-06, 2000 WL 206374, at *5-6 (W.D. Tex. Jan. 18, 2000) (allowing a 58% discount).

84. Short, *supra* note 38, at 697 (explaining that FLP interests are valued at fair market value or what a willing buyer would pay; thus, discounts are applied to reflect restrictions). In an FLP, the property transferred is an interest in the partnership, not the property owned by the partnership. *Id.*

85. *See* Estate of Strangi v. Comm'r, 115 T.C. 478, 487-90 (2000); *see also* Church v. United States, No. SA-97-CA-0774-06, 2000 WL 206374, at *5 (W.D. Tex. Jan. 18, 2000).

86. *See Strangi*, 115 T.C. at 487-90. *See also Church*, 2000 WL at *5 (holding that I.R.C. § 2703 did not apply because the transfer was of partnership interests, not assets; therefore, the restrictions were not to be ignored).

> [T]he value of any property shall be determined without regard to . . . (2) any restriction on the right to sell or use the property . . . [unless it] meets each of the following requirements: (1) It is a bona fide business arrangement. (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.[87]

The "restrictions" include "[a]ny option, agreement, or other right to acquire or use the property at a price less than fair market value; or [a]ny restrictions on the right to sell or use the property."[88] Additionally, these "restrictions" include limitations contained in partnership agreement provisions.[89] The purpose of disregarding the restrictions for property valuation is to prevent discounting abuses.[90]

In the past, the IRS has argued unsuccessfully that the underlying assets in an FLP are "property" for the purposes of I.R.C. § 2703(a) and the FLP itself is a "restriction on the right to sell or use [the] property."[91] In *Estate of Strangi v. Commissioner of Internal Revenue*, the IRS argued that "property" as stated in I.R.C. § 2703 made reference to the underlying assets of the partnership, and as such, the restrictions on the right to sell or use those assets should be disregarded.[92] The court responded by stating that restrictions on the use of partnership assets were irrelevant because partnership interests—not assets—were transferred; thus, the tax court rejected the § 2703 argument.[93] Because the court rejected § 2703(a), it reasoned that § 2703(b) was not applicable.[94]

In contrast, a more recent application of § 2703 to disallow a specific

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87. I.R.C. § 2703 (2008). Section 2703(a) states that property should be valued without taking into consideration restrictions in the partnership agreement. *Id.* § 2703(a). Section 2703(b) provides an exception to Section 2703(a) if the three requirements set forth therein are met. *Id.* § 2703(b).

88. 26 C.F.R. § 25.2703-1(a)(2) (2008).

89. *Id.* § 25.2703-1(a)(3).

90. Droubay, *supra* note 26, at 527-28 (discussing the IRS's attempts to apply Section 2703 in an effort to disregard restrictions for valuation purposes).

91. *See* Estate of Strangi v. Comm'r, 115 T.C. 478, 488 (2000). Section 2703 has been applied narrowly to prevent exclusion of ordinary valuation discounts because of the "mere existence of a partnership." Goldberg, *supra* note 39, at 63. The IRS has argued that an FLP should be disregarded pursuant to § 2703 and that transfers of partnership interests should be treated as transfers of the underlying assets. *See* I.R.S. Tech Adv. Mem. 97-35-003 (May 8, 1997).

92. *Strangi*, 115 T.C. at 488.

93. *Id.* at 488-89.

94. *Id.* at 489.

partnership provision fixing the price of a partnership interest at less than fair market has proven successful.[95] The partnership agreement in *Smith v. United States* contained a restrictive provision which placed a limit on the price for which the partnership could purchase limited interests if it chose to exercise its right of first refusal.[96] The *Smith* court held that the restriction in the "Smith agreement" was "precisely the type of restriction to which § 2703(a) was intended to apply."[97] Although the *Smith* court did not address the effect that application of § 2703 could have on valuation discounts, a disallowance of specific transfer restrictions may potentially lead to a discount reduction.[98]

Assuming that a specific restriction in a partnership agreement satisfies § 2703(a), the exception of § 2703(b) will still allow the restriction to be considered for valuation purposes if each of the three tests provided in § 2703(b) is fulfilled.[99] Thus, if § 2703(a) is satisfied, the three tests of § 2703(b) will follow.[100] If all three tests of § 2703(b) are not met, the restriction will be disregarded for valuation of the partnership interests.[101]

a. Bona Fide Business Arrangement Test

I.R.C. § 2703(b) fails to define a "bona fide business arrangement."[102] However, courts have held that the entity upon which the restrictions are imposed does not have to be an actively managed business.[103] Additionally, the court in *Estate of Harrison v. Commissioner of Internal Revenue*

95. Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, at *14-16 (W.D. Pa. June 30, 2004).

96. *Id.*

97. *Id.* at *14. The restriction, however, could be considered for valuation purposes if the restriction met all three requirements of 2703(b). *Id.* at *16. The court applied three tests to determine if the § 2703(b) exception applied: (1) the bona fide business arrangement test, (2) the testamentary device test, and (3) the similar arrangement or comparability test. *Id.* at *16-23.

98. *See* Renkemeyer, *supra* note 7, at 601, 606 (explaining that restrictions in the partnership agreement may provide valuation discounts).

99. I.R.C. § 2703(b) (2008).

100. Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, at *16-23 (W.D. Pa. June 30, 2004). The *Smith* court briefly examined each of these tests. *Id.*

101. I.R.C. § 2703 (2008).

102. *Id.* § 2703(b).

103. *See* Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, *11-12 (West 2006), *cited in* Holman v. Comm'r, 130 T.C. No. 12, *15 (West 2008). The *Amlie* court determined that a fixed value set for selling the decedent's bank stock was valid even though the heir resold the shares a month later for more than the fixed price. *Id.* at *7-10. The court held that the conservator "was seeking to exercise prudent management of decedent's assets." *Id.* at *42. *See also* Estate of Bischoff v. Comm'r, 69 T.C. 32, 40-41 (1977). Courts have also "consistently recognized that an arrangement to facilitate the maintenance of family ownership and control of a business is a bona fide business arrangement." Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, *17 (W.D. Pa. June 30, 2004).

recognized a valid business purpose when a partnership was created to properly manage assets and was in the best interest of the decedent.[104] Nevertheless, other courts have recognized that carrying on a business requires more than holding securities and keeping records.[105]

b. Device Test

If the restriction at issue meets the requirements of the business purpose test, the court will next consider the "device" test.[106] I.R.C. § 2703(b)(2) requires that restrictions in the partnership agreement must not be "a device to transfer . . . property to members of the decedent's family for less than full and adequate consideration."[107] Determining whether a specific restriction is simply a testamentary device typically requires an analysis into each party's intentions at the formation of the partnership agreement.[108] The court should also consider a party's ability to selectively enforce the specific provision and "the nature and extent of the negotiations that occurred among the parties regarding the terms of the restrictive provision."[109]

c. Comparable Terms Test

Lastly, a court should consider the "comparable terms" test.[110] Section 2703(b)(3) requires that the restriction "has terms that are comparable to similar arrangements entered into by persons in an arm's length transaction."[111] Essentially, the restriction should conform to the restrictions of other similar entities.[112] Past courts have suggested a rather strict evidentiary requirement when applying a comparable terms test.[113]

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104. Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306, 1309 (1987).

105. Higgins v. Comm'r, 312 U.S. 212, 218 (1941).

106. I.R.C. § 2703(b)(2) (2008).

107. *Id.* Secretary regulations, however, substitute "members of the decedent's family" with "the natural objects of the transferor's bounty." 26 C.F.R. § 25.2703-1(b)(1)(ii) (2008). This is likely to illustrate that § 2703 applies not only to testamentary transactions but also to inter vivos transfers. Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, at *17 (W.D. Pa. June 30, 2004).

108. *Smith*, 2004 U.S. Dist. LEXIS at *20; *see also* Estate of Lauder v. Comm'r, 64 T.C.M. (CCH) 1643 (1992).

109. *Smith*, 2004 U.S. Dist. LEXIS at *20-21.

110. I.R.C. § 2703(b)(3) (2008).

111. *Id.*

112. 26 C.F.R. § 25.2703-1(b)(4)(i) (2008) (providing that the restriction should "conform with the general practice of unrelated parties under negotiated agreements in the same business.").

113. *See* Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, at 22-24 (W.D. Pa. June 30, 2004) (requiring testimony to verify similar agreements of comparable companies); *see also* Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, *53 (West 2004), *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005) (placing a strict evidentiary burden on the plaintiff for buy-

As case law has shown, the IRS has utilized different methods to challenge FLPs in an attempt to eliminate the tax benefits provided by this entity. The IRS most recently challenged the validity of an FLP's valuation discounts in *Holman.*

IV. COURT'S DECISION

In *Holman,* the United States Tax Court upheld the petitioners' claim that the stocks were transfers of partnership interests; however, the court reduced the substantial valuation discounts which had been applied to the transfers.[114] Lowering the discounts caused the fair market value of the gifts to increase, resulting in an increase in gift taxes for the Holmans.[115]

A. REJECTION OF INDIRECT GIFT THROUGH APPLICATION OF *SHEPHERD/SENDA*

The court began by discussing the proper tax treatment of the Dell stock gifts to the Holman children.[116] The IRS argued that the transferred property was Dell stock and not limited partnership units; therefore, the value of the stock transferred should have been taxed under U.S.C. § 2501(a)(1) without regard to valuation discounts.[117] The Holmans alleged that the stock was contributed to the FLP and each partner received his share of interests before the transfers were made to the children; therefore, the gift transfers were of LP interests.[118] The IRS urged the court to compare the current case with the facts in *Shepherd* and *Senda.*[119]

The court distinguished the present case from *Shepherd* and *Senda* by finding that the Holmans' transfer of stock to the FLP in 1999 was not an indirect gift of shares to the children.[120] The court recognized that on November 3, 1999, the Holmans formed the partnership; that same day,

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sell agreements).

114. Holman v. Comm'r, 130 T.C. No. 12, *1 (West 2008). The Tax Court reduced the 49.25% discounts applied to the 1999, 2000, and 2001 gifts to 22.4%, 25.05%, and 16.55% respectively. *Id.* at *28. For the purposes of this Note, only the effects of § 2703 on the discounts will be discussed.

115. *Id.*

116. *Id.* at *9.

117. *Id.* at *10.

118. Holman v. Comm'r, 130 T.C. No. 12, *10 (West 2008).

119. *Id.* Both *Shepherd* and *Senda* held that the transfers were indirect gifts. Sheperd v. Comm'r, 115 T.C. 376, 385-86 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002); Senda v. Comm'r, 433 F.3d 1044, 1046-48 (8th Cir. 2006).

120. Holman v. Comm'r, 130 T.C. No. 12, *11 (West 2008). The IRS cited both *Shepherd* and *Senda* claiming that the facts of those cases were similar to the case at bar; however; the court distinguished the present case by stating that the Holmans transferred the LP interest subsequent to the transfers of stock. *Id.*

they funded the partnership by contributing 70,000 shares of Dell stock.[121] It noted that, in return for the contribution made, the "partners received partnership interests proportional to the number of shares each [contributed]."[122] It further noted that it was not until five days later that the Holmans made a gift of LP interests.[123] The court reasoned that the partnership was already formed at the time of the first gift transfer; therefore, it was not a transfer of shares of stock but instead a transfer of LP interests.[124]

B. REJECTION OF INDIRECT GIFT UNDER STEP TRANSACTION DOCTRINE

The court further rejected the IRS's contention that the Holmans made an indirect gift under the step transaction doctrine.[125] The court stated that the IRS seemed to rely on the interdependence test.[126] The court noted that the step transaction doctrine is invoked under the interdependence test when:

> "[T]he steps in a series of transactions are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series . . . . We must determine whether the individual steps had independent significance or whether they had significance only as part of a larger transaction."[127]

The IRS argued that the series of transactions made by the Holmans were interdependent and that the time between the formation, the funding, and the gift was only observed so that the Holmans could avoid treatment of the transfer as an indirect gift pursuant to 26 C.F.R. § 25.2511-1(h)(1).[128] The IRS contended that the creation of the FLP, the transfer of stock, and the gifts to the children were so reliant on one another that completion of one step would have been pointless without completion of the others.[129] The IRS relied heavily on the *Senda* court's opinion which stated, "[i]n

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121. Holman v. Comm'r, 130 T.C. No. 12, *11 (West 2008). The partnership was validly formed under state law, and the stock was transferred before the 1999 gift was made. *Id.*

122. *Id.* at *11.

123. *Id.*

124. *Id.* at *11-13.

125. Holman v. Comm'r, 130 T.C. No. 12, *14 (West 2008).

126. *Id.* at *12. The IRS did not state under which of the three methods of the doctrine it was pursuing the claim; however, the IRS's reasoning suggested application of the "interdependence test." *Id.*

127. Holman v. Comm'r, 130 T.C. No. 12, *1 (West 2008).

128. *Id.* The IRS alleged that the transactions should have been treated as occurring simultaneously. *Id.*

129. *Id.*

some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction."[130]

The court acknowledged that the primary purpose for formation and funding of the FLP was to make gifts to the children; however, it was not persuaded that the partnership would have been useless without the 1999 gift.[131] The court distinguished this case from *Senda* by stating that the Holmans did not make the contributions of stock to the partnership on the same day that they made the gift; in fact, almost one week had passed between funding and the initial transfer.[132] The court further noted that the IRS did not claim that the step transaction doctrine should be applied to the gifts made two months after creation of the FLP; thus, the respondent seemed to concede that time plays an important factor in determining application of the doctrine.[133]

A contributing factor to the court's decision was that the value of the LP interests varied between the date of formation and the date of the gift transfer due to a fluctuation in the value of the underlying Dell stock.[134] The court determined that the formation/funding of the partnership and the subsequent gifts should be considered independently because the Holmans "bore a real economic risk of a change in value of the partnership" during the six day period between the funding of the partnership and the first transfer of partnership interests.[135] Consequently, the court rejected the IRS's application of the step transaction doctrine.[136]

The court reasoned that the time between funding and transferring gifts was an important factor; however, the risks to which the partners were exposed during that time were a central issue regarding application of the step transaction doctrine.[137]

130. Holman v. Comm'r, 130 T.C. No. 12, *12-13 (West 2008) (citing Senda v. Comm'r, 433 F.3d 1044, 1048 (8th Cir. 2006)).

131. *Id.* at *12-13.

132. *Id.* at *13. Nevertheless, the court did not state that the interest had to be transferred on the same day that the partnership was funded for the step transaction doctrine to be invoked. *Id.*

133. *Id.*

134. *Id.*

135. Holman v. Comm'r, 130 T.C. No. 12, *13 (West 2008).

136. *Id.* The court refused to ignore the passage of time between formation and gifting as a factor in determining whether the transfers would be considered indirect gifts. *Id.* The court stated that the Holmans were subject to the risk that the value of the stock could change substantially during the six-day period. *Id.*

137. *Id.*

C. APPLICATION OF I.R.C. § 2703 TO REDUCE VALUATION DISCOUNTS

Next, the court considered the application of I.R.C. § 2703 to the specific transfer restrictions in the Holman Agreement.[138] Paragraphs 9.1, 9.2, and 9.3 of the Holman Agreement contained restrictions on the rights of a limited partner to sell or assign his or her partnership interest; thus § 2703(a) was satisfied.[139] Therefore, it was necessary for the court to apply

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138. Holman v. Comm'r, 130 T.C. No. 12, *14 (West 2008).

139. *Id.* at *4-6. Paragraph 9.1 of the Holman Agreement stated, "A Limited Partner may not without the prior written consent of all Partners assign (including by encumbrance), whether voluntarily or involuntarily, all or part of his or her Interest in the Partnership, except as permitted by this Agreement." *Id.* at *4. Paragraph 9.2 stated:

> A Limited Partner may assign all or any portion of his or her Interest in the Partnership to a revocable trust the entire beneficial interest of which is owned by the Partner. In addition, a Limited Partner may assign all or any portion of his or her Interest in the Partnership, at any time or from time to time, during lifetime or upon death, to a Family member; to a custodian for a Family member under an applicable Uniform Transfers to Minors Act; to another Partner; or to trustees, *inter vivos* or testamentary, holding property in trust for Family members (notwithstanding that someone who is not a Family member may also be a beneficiary of such trust).

Id. Paragraph 9.3 stated:

> If an assignment of a Partnership Interest occurs which is prohibited or rendered void by the terms of this Agreement, but the General Partners determine that such assignment is nevertheless effective according to then applicable law, the Partnership shall have the option (but not the obligation) to acquire the Interest of the assignee or transferee upon the following terms and conditions: (1) The Partnership will have the option to acquire the Interest by giving written notice of its intent to purchase to the transferee or assignee within ninety (90) days from the date the Partnership is notified in writing of the transfer or assignment. (2) Unless the Partnership and the transferee or assignee agree otherwise, the purchase price for the Interest, or any fraction to be acquired by the Partnership, shall be its fair market value based upon the assignee's right to share in distributions from the Partnership, as determined by an appraisal performed by an independent appraiser selected by the General Partners. (3) The valuation date for the determination of the purchase price of the Interest will be the date of death in the case of an assignment due to death or, in all other cases, the first day of the month following the month in which the Partnership is notified in writing of the assignment. (4) The closing of the purchase of the Interest shall occur no later than one hundred eighty (180) days after the valuation date, as defined in (3) above. (5) In order to reduce the burden upon the resources of the Partnership, the Partnership will have the option, to be exercised in writing delivered at closing, to pay ten percent (10%) of the purchase price at closing and pay the balance of the purchase price in five (5) equal annual installments of principal (or equal annual installments over the remaining term of the Partnership if less than five (5) years), together with interest at the Applicable Federal Rate (as that term is defined in the Code) which is in effect for the month in which the closing occurs. The first annual installment of principal, with accrued interest, will be due and payable exactly one year after the date of closing, and subsequent annual installments of principal, with accrued interest, will be due and payable each year thereafter on the anniversary date of the closing until five (5) years after the date of closing (or shorter term, if applicable), when the remaining amount of the obligation, with unpaid accrued interest, shall be paid in full. The Partnership will have the right to prepay all or any part of the remaining obligation at any time without penalty. (6) By consent of the Partners (other than the Partner whose interest is to be acquired), the General Partners may assign the Partnership's option to purchase to one or more Partners and when done, any rights or obligations imposed upon the Partnership will instead become, by substitution, the rights and obligations of such Partners. (7) If the option to purchase under this paragraph 9.3 is not exercised, the assignee may retain the assigned Interest provided the assignee agrees in writing to be bound by the terms and conditions of this Agreement. The assignee shall not become a Limited Partner unless all of the other Partners consent, which consent may be granted or withheld in their sole discretion,

the tests of § 2703(b) to determine if the restrictions of paragraph 9.1 through 9.3 should be disregarded for valuation purposes.[140]

1. BONA FIDE BUSINESS ARRANGEMENT

The court began its discussion of § 2703 by considering whether the restrictions contained in 9.1 through 9.3 served a bona fide business arrangement.[141] The IRS argued that the Holmans' primary objective in creating the FLP was to preserve the family wealth, and this personal goal was not a sufficient business purpose.[142] The court acknowledged that "buy-sell agreements serve a legitimate purpose in maintaining control of a closely held business"; however, it refused to recognize the Holman FLP as a closely held business.[143]

The court focused on the reasoning of the court in *Estate of Amlie v. Commissioner of Internal Revenue* for its discussion of a closely held business constituting a "bona fide business arrangement."[144] The court distinguished *Holman* by recognizing that the conservator in *Amlie* was providing for the liquidity needs of the estate by fixing the price of the minority interest.[145]

The court reasoned that the Holman FLP had very limited activity with the exception of holding Dell stock.[146] Even though paragraphs 9.1 through 9.3 were intended to "aid in the control" of partnership interests, the court determined that the paragraphs did not serve a business purpose when considered in relation to the purposes of the partnership as stated in

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> and the other conditions for admission contained in this Article IX are satisfied. The rights of an assignee who does not become a Limited Partner shall be limited to the right to receive, to the extent assigned, only the distributions to which the assignor would be entitled under this Agreement.

Id. at *5-6.

140. Holman v. Comm'r, 130 T.C. No. 12, *14-19 (West 2008). If the paragraphs fulfilled all three tests of § 2703(b), then the restrictions could be considered. *Id.* at *14.

141. *Id.* at *14-15.

142. *Id.* at *14.

143. *Id.* at *15-16. In its reasoning, the court cited a Committee Finance Report pertaining to buy-sell agreements:

> Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance.

Id.

144. Holman v. Comm'r, 130 T.C. No. 12, *16 (West 2008) (citing Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (2006)).

145. *Id.* at *15-16. The *Holman* court reasoned that the conservator's actions in *Amilie* were in the best interests of the estate. *Id.* at *16.

146. *Id.*

the Holmans' testimony.[147] The court concluded that the Holmans' main goals in forming the FLP were "educating their children [on] wealth management and disincentivizing [sic] them from getting rid of Dell shares," and that these goals were inconsistent with the Committee on Finance Report justifying buy-sell agreements.[148]

2. DEVICE TEST

The next element the court addressed with regard to § 2703 was whether the restrictions contained in paragraphs 9.1 through 9.3 were a device to transfer property to the "natural objects of the transferor's bounty" for less than full and adequate consideration.[149] The court immediately recognized that the gifts of LP units were not a "device" to transfer the partnership interests to the children for insufficient consideration.[150] Instead, the court focused on whether the restrictions contained in the specific paragraphs (9.1-9.3) constituted such a "device."[151]

The court reasoned that the transfer restrictions discourage the children's dissipation of wealth by denying the children the ability to "realize the difference in value between the fair market value of [their] LP units and the units' proportionate share of the partnership's [net asset value]."[152] The court implied that the Holmans were fully aware of their ability "to redistribute wealth from a child pursuing an impermissible transfer to [their] other children" pursuant to paragraph 9.3.[153] Thus, the court held that paragraph 9.3 was a device to transfer partnership interests "to the natural objects of the petitioners' bounty for less than adequate consideration."[154]

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147. Holman v. Comm'r, 130 T.C. No. 12, *16 (West 2008) (citing Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (2006)).

148. *Id.*; *see* 136 Cong. Rec. 30,485, 30,539 (daily ed. Oct. 18, 1990) (report by committee representatives on the Omnibus Budged Reconciliation Act of 1990) (recognizing that valid buy-sell agreements commonly contain valid restrictions that prevent transfers to an unrelated party).

149. Holman, 130 T.C. No. 12 at *17 (West 2008) (quoting 26 C.F.R. § 25.2703-1(b)(1)(ii) (2008)).

150. *Id.* This confirmed prior case history that § 2703 would not be applied to disregard the entire FLP for valuation purposes. *See* Estate of Strangi v. Comm'r, 115 T.C. 478, 488 (2001). If the entire partnership were disregarded, the underlying assets would be valued at fair market value with no discounts. *See supra* note 90.

151. Holman v. Comm'r, 130 T.C. No. 12, *17 (West 2008).

152. *Id.*

153. *Id.*

154. *Id.* Paragraph 9.3 permitted the partnership to repurchase impermissible transfers at a discounted price. *Id.* at *5. If exercised, this paragraph would have allowed the LP units to be repurchased for less than the net asset value, which would have consequently increased the value of the remaining partners' interests. *Id.* at *17. The court stated that paragraphs 9.1 through 9.3 were a device to transfer the LP units to the children for less than adequate consideration;

3. COMPARABLE TERMS

The last element of § 2703 that the court considered was whether restrictions contained in paragraphs 9.1 through 9.3 were common in agreements entered into in an "arm's-length transaction."[155] Both parties' experts agreed that the restrictions contained in paragraphs 9.1 through 9.3 were common in similar arm's length agreements.[156] The IRS's expert, however, argued "that the overall circumstances of the partnership arrangement made it unlikely that a person in an arm's-length arrangement with the [Holmans] would accept any of the salient restrictions on sale or use"; thus, the restrictions would never be an issue.[157]

The court avoided a direct application of the comparability test and chose not to rule on the issue.[158] The court failed to make a decision as to whether the IRS's expert was correct in viewing the entirety of the arm's length transaction.[159] The court justified its decision not to reach the comparability test by stating that even if paragraphs 9.1 through 9.3 satisfied the comparability test, the paragraphs should still be disregarded for valuation purposes because they did not serve a "bona fide business purpose" and they were a prohibited device; therefore, these paragraphs contained prohibited restrictions.[160] Thus, the court disregarded the restrictions of paragraphs 9.1 through 9.3 for gift tax valuation purposes.[161]

V. ANALYSIS

A. REJECTION OF STEP TRANSACTION THEORY

One of the most significant ramifications of the *Holman* decision is its rejection of the IRS's step transaction doctrine theory.[162] Although the court conceded that the Holmans formed the FLP with the primary intention

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however, it only provided reasoning for paragraph 9.3. *Id.* at *17.

155. Holman v. Comm'r, 130 T.C. No. 12, *18 (West 2008).

156. *Id.*

157. *Id.* The IRS's expert stated,

> [W]hen you look at the overall context, when you look at the nature of the assets, when you look at the expertise or non-expertise of the general partner, when you look at the 50-year term, when you look at the inability to get out, when you look at the susceptibility of this single asset . . . the issue . . . wouldn't arise, because nobody at arm's length would get into this deal.

Id.

158. *Id.* at *19.

159. *Id.*

160. Holman v. Comm'r, 130 T.C. No. 12, *19 (West 2008).

161. *Id.*

162. *Id.* The IRS utilized this doctrine in an attempt to value gifts of partnership interests made shortly after FLP formation as indirect gifts of underlying assets not subject to valuation discounts. *Id.* at *13.

of making gifts, it recognized that the Holmans were vulnerable to "real economic risk" of fluctuations in value during the period between funding of the FLP and the first gift.[163] Thus, the court rejected the IRS's contention that the formation, funding, and gift were all one integrated transaction.[164] The court's analysis regarding the step-transaction doctrine serves as a safeguard for the validity of future FLPs, so long as there exists a real economic risk in the interim between formation of the FLP and the transfer of the first gift.

This case clarifies *Senda*'s application of the step transaction doctrine. In *Senda*, there was insufficient evidence as to whether the partnership interests were transferred to the children before or after the contribution of the stock.[165] As a result, application of the step transaction doctrine in *Senda* left taxpayers and planners guessing on an acceptable amount of time to wait before transferring LP interests.

While the *Holman* court acknowledged that the very short amount of time between funding and the transfer of interests was a significant factor, it was not itself determinative.[166] The dispositive factor that led to the court's rejection of the step transaction doctrine was the reality that the Holmans were subject to a possible change in the value of the partnership interests.[167]

Based on the court's reasoning, the time period required to integrate the transactions will vary depending on the underlying assets of the FLP.[168] The *Holman* analysis suggests that if the value of the underlying assets is not likely to vary, then the time period necessary for an integration of the steps will be extended.[169] This proposed balancing test between variance of underlying assets and passage of time will likely be a pivotal point of future FLP litigation.[170]

163. Holman v. Comm'r, 130 T.C. No. 12, *13 (West 2008). The percentage change in the average price of a share of Dell stock between November 2, 1999, and January 4, 2000, was +17.75%. *Id.* Between November 2, 1999, and February 2, 2001, the percentage change was -35.75%. *Id.* Thus, the stock price was unpredictable. *Id.*

164. *Id.*

165. Senda v. Comm'r, 88 T.C.M. (CCH) 8, *16 (West 2004).

166. Holman v. Comm'r, 130 T.C. No. 12, *6, *13 (West 2008).

167. *Id.*

168. *Id.* at *13. The court failed to offer a bright-line test but gave planners a modicum of guidance with its analysis. *Id.*

169. *Id.*

170. Neither regulation nor present case law has provided a determinate amount of time from FLP formation to partnership interest transfer that is safe from potential dispute. In light of *Holman*, the tax court in *Gross v. Commissioner* used the same analysis applied in *Holman* to reject application of the step transaction doctrine. Gross v. Comm'r, 96 T.C.M. (CCH) 187, *23-25 (West 2008). In *Gross*, 11 days passed between conclusion of the petitioner's transfers of stock to the FLP and the subsequent gifts of partnership interests to the daughters. *Id.* The

With respect to the indirect gifts, *Holman* sends two important messages to FLP planners: (1) make certain that the FLP is properly formed and funded before making gifts of partnership interests; and (2) leave enough time between the funding of the FLP and the transfers of partnership interests to ensure sufficient time for "a real economic risk of change in value" to occur.[171]

The problem with the court's interpretation of the step transaction theory is that it failed to provide definite guidelines for future taxpayers to follow. The court offered some guidance but ultimately left the application of the doctrine arbitrary.[172] Instead of basing its decision on proper formation and funding before the transfers, the court relied on the amount of risk to which the Holmans were subject.[173] Regardless of the risk taken by the Holmans, the court should have considered the FLP valid by completely rejecting the step transaction doctrine.[174] Leaving doubt about whether the step transaction doctrine will apply—despite the FLP being properly formed and funded—will lead to many unanswered questions and unintended liability for taxpayers.[175]

majority of the securities transferred were common shares of well-known companies. *Id.* at *24-25. The court held that the transfers were gifts of partnership interests rather than gifts of stock. Gross v. Comm'r, 96 T.C.M. (CCH) 187, *27 (West 2008). In its reasoning, the court stated that a "real economic risk of a change in value arises from the nature of the Dimar securities as heavily traded, relatively volatile common stock." *Id.* at *25. The court further noted, "We might view the impact of a 11-day hiatus differently in the case of another type of investment; e.g., a preferred stock or a long-term government bond." *Id.*

171. According to *Holman*, the underlying assets of the FLP will determine how much time should be allowed between funding and gifts of interests. Holman v. Comm'r, 130 T.C. No. 12, *13 (West 2008). The higher the risk of a shift in value, the less time required before the gifts can properly be made. *Id.*

172. *Id.*

173. *Id.*

174. The FLP was properly formed and funded before the transfers were made six days later. *Id.* at *3. According to the court's analysis, the step transaction doctrine could have possibly been applied had the transfers been made quicker. *Id.* at *13. The court should have put an end to the step transaction doctrine's possible application to FLPs by completely rejecting the doctrine as long as the FLP was properly formed and funded before transfers were made. On the other hand, the step transaction doctrine should still apply if the formation, funding, and gift transfers become intermingled. *See* Senda v. Comm'r, 88 T.C.M. (CCH) 8, *16-17 (West 2008).

175. For example, the court stated that it may have held differently had the FLP held a less volatile asset. Holman v. Comm'r, 130 T.C. No. 12, *13 n.7 (West 2008). Thus, a taxpayer transferring interest in an FLP that has only land as an underlying asset would have no guidance as to when it would be proper to transfer the interests. Allocating a month's time between formation, funding, and the transfers may not even be sufficient. The court left a huge gap in its reasoning that may cause many future problems. Rejecting the doctrine outright, as applicable to transfers from an FLP, would have solved this problem.

B. BONA FIDE BUSINESS ARRANGEMENT UNDER I.R.C. § 2703

As a result of *Holman*, restrictions providing for control of ownership in an FLP will not be sufficient to satisfy the business purpose outlined in § 2703 when the FLP is not a closely held business.[176] The *Holman* court's censure of the Holman Agreement for its lack of a "bona fide" business purpose creates concern because many FLPs designed to gift assets to children contain restrictions similar to those found in the Holman Agreement. In future cases, individuals attempting to utilize an FLP as a vehicle to preserve familial wealth may have to prove a significant business purpose to validate their FLP.

The *Holman* court failed to acknowledge the Holmans' claim that the restrictions in paragraphs 9.1 through 9.3 were a "safety net" to prevent ownership from falling into the wrong hands.[177] Instead, the court stated that the justifications contained in the Committee on Finance report were not aligned with the Holmans' goals.[178] The court's rejection of the bona fide business purpose in this agreement could mean a rejection of other similar agreements in the future.[179] Accordingly, the *Holman* decision could create a trend toward disallowing specific partnership provisions, resulting in a reduction of valuation discounts claimed by the FLP.

C. COMPARABILITY TEST UNDER I.R.C. § 2703

The *Holman* court should have addressed the IRS's expert's contentions that the transfer restrictions of paragraphs 9.1 through 9.3 failed to meet the comparability test.[180] Despite the fact that this test was a moot point for the purpose of *Holman* decision, the court's failure to properly consider it could mislead taxpayers and estate planners.[181] Prior cases have suggested a strict evidentiary requirement when applying the comparable terms analysis;[182] however, *Holman*'s cursory treatment of the test could

176. Holman v. Comm'r, 130 T.C. No. 12, *15-16 (West 2008).

177. *Id.* at *16.

178. *Id.* One of the legitimate business reasons set forth by the Committee on Finance report was to prevent transfers to unrelated parties. *Id.* at *15.

179. Holman v. Comm'r, 130 T.C. No. 12, *16 (West 2008).

180. The IRS's expert felt that the reading of § 2703's comparability test should be approached from a broad perspective, considering the entire arm's length transaction. *Id.* at *8.

181. The court stated, "[t]he experts agree that transfer restrictions comparable to [these] are common in agreements entered into at arm's length. That would seem to be all that petitioners need to show to satisfy [the comparability test]." *Id.* at *19.

182. *See* Smith v. United States, No. 02-264, 2004 U.S. Dist. LEXIS 14839, at *22-24 (W.D. Pa. June 30, 2004); *see also* Estate of Blount v. Comm'r, 87 T.C.M. (CCH) 1303, *53-56 (West 2004), *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005). The *Holman* court simply dismissed having to decide whether the comparability test was met because the bona fide business purpose test and the device test were not met. Holman v. Comm'r, 130 T.C. No. 12, *18 (West

give taxpayers/planners the false impression that this requirement has been lowered.

D. TRANSFER RESTRICTIONS AND THEIR IMPACT ON VALUATION

The *Holman* court's refusal to recognize paragraphs 9.1 through 9.3 of the FLP agreement appears to have had little impact on the valuation of the partnership interests.[183] The court's thorough discussion of § 2703 and its refusal to recognize the repurchase restriction in paragraph 9.3 led to only a small reduction in the available lack-of-control discount.[184]

The IRS's expert believed that paragraph 9.3 would have no impact on valuation beyond the lack-of-control and minority interest discounts while the Holmans' expert believed that paragraph 9.3 would reduce the lack-of-control discount by only 2.44%.[185] If the Holmans had planned more properly and met the buy-sell agreement guidelines of § 2703, then the court would have likely allowed a slight increase in the lack-of-control discount. Although the court determined that this refusal to recognize the repurchase restriction led to only a small reduction in the available discount, a small discount could still yield significant tax savings.[186]

While a small discount could possibly produce significant tax savings, the court's refusal to recognize specific FLP restrictions pursuant to § 2703 would likely have little effect on the future of valuation discounts. Consequently, if the IRS continues to attack specific transfer restrictions pursuant to § 2703, it will likely have little impact on the effectiveness of the FLP as a tax saving entity.[187] The *Holman* court's allowance of significant discounts follows the tendency of the tax court and signifies a

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2008). Under this rationale, the court should not have considered the device test once the bona fide business purpose test failed. By considering the device test but not the comparability test, the court inadvertently undermined the importance of the comparability test. The court should have given proper attention to all three tests, or it should have determined that neither the device test nor the comparability test were to be considered once the bona fide business purpose test failed.

183. *See Holman*, 130 T.C. No. 12 at App. A-D.

184. *Id.* at *18. The Holmans' expert believed that paragraph 9.3 would reduce the lack-of-control discount by only 2.44%. *Id.* at App. A-D.

185. The Holmans' expert valued the gift at $228,832 when 9.3 was disregarded and at $223,250 when 9.3 was taken into account. Holman v. Comm'r, 130 T.C. No. 12, App. A-D (West 2008). Thus, (228,832-223,250)/228,832 = 2.44%; if this calculation is applied to the other gifts, the result will be the same. *Id.*

186. For instance, assuming that the value of an FLP's underlying assets is $10,000,000 (without discounts), a 2.5% discount would reduce the taxable base of the assets by $250,000.

187. A discount reduction of approximately 2.5% would have a noticeable effect on only large gifts. The *Holman* court still allowed significant discounts. Holman v. Comm'r, 130 T.C. No. 12, *24, *28 (West 2008).

continued recognition of the FLP as a tool for wealth transfer.[188] Because valuation discounts allow gifts to be transferred at a reduced price, FLPs should make certain to comply with the proper principles articulated in *Holman* to receive maximum tax benefits.

VI. CONCLUSION

FLPs continue to be a valuable estate and gift tax planning tool for transferring family wealth while minimizing tax liability. The *Holman* court established that a taxpayer's vulnerability to economic risks between the formation/funding of an FLP and subsequent gift transfers is of paramount importance. The IRS will continue to search for theories to restrict future application of these beneficial discounts. Nevertheless, proper planning will likely enable taxpayers to continue to reap the gift and estate tax benefits offered by these complex entities.

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188. In the past, courts have been willing to extend significant discounts to FLPs. *See, e.g.*, Adams v. United States, 2001 U.S. Dist. LEXIS 13092, at *18-25 (N.D. Tex. Aug. 24, 2001) (allowing a 53% discount); Dailey v. Comm'r, 82 T.C.M. (CCH) 710, *8 (West 2002) (allowing a 40% discount).