

**APPEALS COORDINATED ISSUE
SETTLEMENT GUIDELINES**

ISSUE: Discounts for Family Limited Partnerships

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APPEALS SETTLEMENT GUIDELINES

FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY CORPORATIONS

UIL 2031.01-00

Issues

1. Whether the fair market value of transfers of family limited partnership or corporation interests, by death or gift, is properly discounted from the pro rata value of the underlying assets.
2. Whether the fair market value at date of death of I.R.C. §§ 2036 or 2038 transfers should be included in the gross estate.
3. Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.
4. Whether an accuracy-related penalty under I.R.C. § 6662 is applicable to any portion of the deficiency.

Background

Family limited partnerships and family corporations have long been used in the conduct of active businesses, primarily to provide a vehicle for family involvement in the enterprise and for succession planning. In the early 1990's, however, estate planners began using family limited partnerships and family limited liability corporations to hold and transfer passive assets such as stock portfolios, mutual funds, bond portfolios, cash, and similar passive assets that are easily liquidated. The alleged "business" purpose for forming family partnerships or corporations with passive assets was to engage a younger generation in investment decision making.

The IRS initially focused on the question of whether the family limited partnership was valid for tax purposes. Substance over form, step-transaction analysis, and lack of business purpose theories were used by the IRS to essentially set aside the transaction for estate and gift tax purposes and include the full value of the assets in determining estate or gift tax liabilities. These arguments are not always successful in litigation. As a result of some well-articulated court decisions, there is now a set of recognized criteria that estate planners can use in establishing family limited partnerships and family limited liability corporations that head off such challenges. The IRS still raises the issue of legitimacy, however, when these criteria have not been followed.

In cases where the IRS cannot successfully argue to set aside the family limited partnership's existence for tax purposes, the focus shifts to determining the correct valuation of its assets. The amount of discount to be applied to the fair market value of the assets is often a source of dispute, with taxpayers arguing that lack of marketability and minority interest factors should result in deep discounts that significantly reduce the tax base.

Thus, the IRS generally considers two basic issues with family limited partnerships: the validity issue (often known as the IRC § 2036 and § 2038 issue) and the valuation issue. The issue of indirect-type gifts, where the transfers of family limited partnership interests are made before, at the same time as funding, or shortly thereafter, is also raised where facts and circumstances support it.

The above should not be taken to preclude Compliance raising other arguments or legal theories that might apply to cases involving family limited partnerships or family limited liability corporations. Each case is factually unique, and interpretation of the law in this area continues to evolve. At the time of this writing Compliance has not published a coordinated issue paper.

The IRS has pursued coordination of family limited partnership issues at both the Compliance and Appeals levels in response to abusive practices. Recently, taxpayers have been forming family limited partnerships and taking excessive discounts from the net asset value of the partnership. More often than not, these cases undervalue passive and/or liquid assets. In addition, there have been cases where the partnership formalities were not followed or where the donor/decedent used the family limited partnership to pay personal expenses. These practices are often tax-avoidance in nature, and therefore looked upon as tax shelters.

When the practices described above clearly violate the intent of the tax law and undermine voluntary compliance, they are considered abusive. The negative impact on our tax system is manifested most immediately in estate and gift tax reporting for transactions involving family limited partnerships. But there is a carryover impact on income taxes as well. Liquidations of, or distributions from, family limited partnerships and limited liability corporations generally result in a recognizable gain subject to income tax. Frequently, however, taxpayers use the *undiscounted* value of the partnership interest to compute the gain, thus improperly understating the reportable income tax on the transaction.

Although related to the valuation issue discussed below, the income tax implications will not be addressed in this document.

Issue 1

Whether the fair market value of transfers of family limited partnership or family limited liability corporation interests by death or gift is properly discounted from the pro rata value of the underlying assets.

Compliance Position

The Government's position is that under certain circumstances, there should be minimal discounts or no discounts from the pro rata value of the underlying asset value of the entity. This position is based upon current case law, reliance on current studies that support minimal discounts for minority interest and lack of marketability, and certain alternative methods of valuation.

Taxpayer's Position

Because of the illiquid nature of the assets involved, taxpayers claim that the fair market value of the transfers are substantially less than the underlying pro rata value of the assets held by the entity. Discounts for minority interest, lack of marketability, and possibly portfolio composition are used by taxpayers to reduce the value of the assets transferred. In addition, the methods of valuation used by the appraiser valuing the entity may contribute to reductions from the underlying pro rata value of the assets.

Discussion

For estate and gift tax purposes, § 2031 of the Internal Revenue Code provides the general rule that transfers from family limited partnerships and family limited liability corporations are valued at their fair market value. Fair market value is generally defined as the value at which a willing buyer would purchase, and a willing seller would sell, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts.

Treas. Reg. § 20.2031-1(b) further expands the definition of fair market value:

The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

With respect to family limited partnerships and family limited liability corporations, an appraisal is usually obtained from a qualified appraiser who determines the fair market value of the interest at some value less than the pro rata value of the underlying assets, either because of the method of valuation used, or because of discounts for lack of marketability and minority interest.

In **Knight v. Commissioner, 115 T.C. 506 (2000)**, although the IRS raised the legitimacy of the family limited partnership for tax purposes, the Tax Court found that under Texas law the partnership had properly been created and was recognizable for federal gift tax purposes. The family limited partnership had been funded primarily with cash, municipal bonds, and real property. However, the Court allowed only a 15% overall discount for lack of marketability and minority interest from the underlying value of the property.

The Tax Court has been using a more sophisticated approach in recent cases, such as **McCord v. Commissioner, 120 T.C. 358 (2003)**; **Lappo v. Commissioner, T.C. Memo. 2003-258**; **Peracchio v. Commissioner, T.C. Memo. 2003-280**; and **Estate of Webster E. Kelley v. Commissioner, T. C. Memo. 2005-235**.

In each of these cases, the appraiser started with the net asset value of the partnership, then analyzed the makeup of the portfolio and divided it into cash, equities, bonds, and real estate, or other types of assets.

For each element of the portfolio, the appraiser looked to comparable funds for an average discount from net asset value. Generally, the appropriate discount was smaller commensurate with the risk of the investment. That is, foreign equities should be expected to have a higher net asset value discount than domestic bonds because foreign equities have an inherently higher risk.

In **McCord v. Commissioner**, the Tax Court extensively analyzed the testimony and opinions of both the Government's and the taxpayer's appraisers to arrive at a discount of 15% for minority interest and 20% for lack of marketability interest for the transferred interests.

The taxpayers had formed a family limited partnership with 2 classes of limited partner's interests; Class A partners were the taxpayers, and Class B partners were the taxpayers, their children, and the children's partnership. The general partners were the children.

In 1996, the taxpayers assigned their Class A interests to charity and their Class B interests to the children, the children's trust, and two charities; the assignments were made according to a formula that allocated the interests based on a set dollar amount.

The taxpayer's appraiser had opined that a 22% minority interest discount and a 35% lack of marketability discount were applicable; while the Government's appraiser opined that an 8.34% minority interest discount and a 7% lack of marketability discount were applicable.

In making its determination on the discounts, the Court considered the discount from the net asset value of samples of comparable funds. The Court considered the following factors in assessing the comparability of the funds:

- The quality of the equities in the sample funds;
- Age of the funds;
- Whether unrealized capital gains are present in the funds;
- The type and quality of management for the sample funds; and
- Whether the funds are scheduled for liquidation or conversion.

The Court accepted the Government appraiser's findings on the appropriate minority discount for the liquid assets, and allowed 10%. With respect to the lack of marketability discount, the Court reviewed the traditional IPO (Initial Public Offering) and restricted stock studies, rejecting the IPO studies on the testimony of the Government's appraiser in favor of the restricted stock studies; ultimately a 20% lack of marketability discount was allowed by the Court.

In **Lappo v. Commissioner**, the Tax Court, after considering the testimony of both taxpayer's and Government's expert witnesses, allowed an overall 15% minority interest discount and an overall 24% marketability discount in determining the fair market value of transfers of a family limited partnership with both active and passive assets.

In **Lappo**, both parties agreed that the marketable securities portion of the family limited partnership should be valued using the net asset value of the partnership. The petitioner's expert used a minority interest discount of 7.5%, while the respondent's expert used a minority interest discount of 8.5%. Since the difference between the experts was not significant, the Tax Court adopted the 8.5% minority interest discount for the marketable securities.

In valuing the real estate component of the portfolio, both appraisers started with REITS and real estate companies as comparable companies for determining minority interest discounts; respondent's expert used 52 comparables, while petitioner's expert used 7 comparables. Some of the factors considered by the Court are as follows:

- Size of the guideline group and comparability of the companies (the Court rejected the taxpayer's group of 7 comparable sales as too small using respondent's expert's sample instead);
- The liquidity component of the discount (the Bajaj study found the liquidity component of the discount was 7.5%).

The Court ultimately allowed a 19% minority interest discount for the real estate portion of the portfolio.

The Court also reviewed recent studies in determining the lack of marketability discount applicable; noting that these studies found 14.09%, 17.6%, and 13.5% discounts for

lack of marketability, respectively. The Court allowed a lack of marketability discount of 24%.

In **Peracchio v. Commissioner**, the Tax Court valued two transferred limited partnership interests: a 45.47% interest transferred to a family trust, and a 53.48% interest sold to the trust in exchange for a promissory note in the amount of \$646,764.

At trial the issue was the fair market value of the family limited partnership interests. Relying on an appraisal, the taxpayer took a 40% discount, while the Government, based upon an appraisal, took a 4.4% lack of control and a 15% lack of marketability discount.

Both appraisers started with fair market value, dividing the family limited partnership's passive assets into categories: cash, U.S Government bonds, state/local bonds, domestic equities, and foreign equities. Each category was assigned a minority interest discount based upon comparable closed end investment funds classified by Lipper Analytical Services.

After analyzing both appraisers' samples, the Tax Court assigned appropriate minority interest discounts as follows:

Cash and money market funds	2.0%
U. S. Government bond funds	6.9%
State and local bonds	3.5%
National municipal bond funds	3.4%
Domestic equities	9.6%
Foreign equities	13.8%

After applying the minority interest discounts to the asset categories, the average minority discount was 6.02%.

With respect to the marketability discount, the Tax Court analyzed the various restricted stock studies, expressing dissatisfaction with both appraisers' analyses, and allowed a final discount of 25%. The total discount allowed by the Tax Court was 29%.

In summary, the discounts allowed by the Tax Court in the above three cases are set forth below:

Case Name	Lack of Control or Minority Interest Discount	Lack of Marketability Discount	Combined Discount
<u>McCord</u>	10%	20%	32%
<u>Lappo</u>	8.5%	24%	27%
<u>Peracchio</u>	6.02%	25%	29%

In the recently decided case, **Estate of Webster E. Kelley v. Commissioner**, the Tax Court allowed a 12% minority discount and a 23% marketability discount for a family limited partnership that consisted solely of cash and certificates of deposit. In allowing this large discount, the Tax Court relied upon appraisals by both the petitioner and respondent that used general equity closed-end funds as comparables. The use of general equity funds as comparable to cash by both the petitioner and the respondent could be criticized, since cash is a more liquid investment than securities. This case was an anomaly for various reasons and should not be considered valuable guidance.

Cases in this area are fact specific. Consequently, each case needs to be individually assessed to determine the appropriate discounts.

Issue 2

Whether the fair market value at date of death of I.R.C. §§ 2036 or 2038 transfers should be included in the gross estate.

Compliance Position

The Government's position is that, where the facts and circumstances indicate the decedent retained a sufficient interest in the transferred property, the property is includible under §§ 2036 or 2038.

Taxpayer's Position

The taxpayer's position is that the transfer of property to a family limited partnership is a bona fide sale for full and adequate consideration, and so is an exception to I.R.C. §§ 2036 and 2038, or, in the alternative, that §§ 2036 and 2038 do not apply to the transaction.

Discussion

I.R.C. § 2036 provides the general rule that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has made a transfer, except in case of a bona fide sale for adequate and full consideration in money or money's worth, under which he has retained for his life (1) the possession or enjoyment of or the right to income from the property, or (2) the right, either alone or in conjunction with another person, to designate the persons who shall possess or enjoy the property or the income there from.

I.R.C. § 2038 provides the general rule that 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), ...where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power by the decedent alone or by the decedent in conjunction with any other person ...to alter, amend, revoke or terminate.

There are numerous cases where the Court has applied the provisions of § 2036(a) to the transfer: **Estate of Schauerhamer**, T.C. Memo. 1997-242; **Estate of Reichardt**, 114 T.C. 144 (2000); **Estate of Harper**, T.C. Memo. 2002-121; **Estate of Abraham**, T.C. Memo. 2004-39, aff'd 408 F.3d 26 (1st Cir. 2005); **Estate of Hillgren**, 87 T.C.M. 1008 (2004); **Estate of Thompson**, T.C. Memo. 2002-246, aff'd Turner v. Commissioner, 382 F.3rd 367 (3rd Cir. 2004); **Estate of Strangi v. Commissioner**, 115 T.C. 478 (2002), aff'd in part rev'd in part Gulig v. Commissioner, 293 F.3d 279 (5th Cir. 2002), rehearing denied Gulig v. Commissioner, 48 Fed. Appx. 108 (2002), on remand at judgment entered Estate of Strangi v. Commissioner, T.C. Memo. 2003-145, aff'd Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005), review or rehearing granted 429 F.3d 1154 (5th Cir. 2005); **Estate of Kimbell**, 371 F.3d 257 (5th Cir. 2004); **Estate of Bongard**, 124 T.C. No. 8 (2005); **Estate of Bigelow**, T.C. Memo. 2005-65; the companion **Korby** cases, T. C. Memo. 2005-102 and 103; and **Estate of Schutt**, T.C. Memo. 2005-126.

In the earliest case, **Estate of Schauerhamer**, the decedent deposited income from partnership assets into her personal bank account and failed to keep any partnership books and records. The Tax Court held that the amount of the partnership transfer was includible in her estate under § 2036(a).

Similarly, in **Estate of Reichardt**, the donor commingled personal funds and continued to use the personal residence, which he had contributed to the partnership, without paying rent. The donor also continued to manage the assets in the same way as he did before the transfer, with sole authority to sign partnership checks and documents. The Tax Court held that the assets transferred were includible in his estate under § 2036(a).

In **Estate of Harper**, the taxpayer commingled personal funds, delayed in transferring funds to the partnership, and made disproportionate distributions to the donor. The Tax Court held that the amount of the transfers was includible in the estate under § 2036(a).

In **Estate of Abraham**, the Tax Court held that transfers of real property to three family limited partnerships were includible under § 2036, because there was an agreement among the siblings that the decedent's need for support would come first from the family limited partnerships. The children so testified in Court and the agreements worked out with the approval of the Probate Court during decedent's guardianship so provided.

Next, in **Estate of Lea Hillgren**, the decedent created a family limited partnership with her brother five months before she committed suicide. The assets were subject to a

business loan arrangement, under which the decedent's brother retained a 25% interest in the partnership, plus a 29-year right to determine whether any of the properties could be sold. Although the Tax Court accepted the business loan agreement as a factor in reducing the value of the real properties, it held that, under § 2036, the properties were brought back into the decedent's estate.

During the five-month period the family limited partnership was in existence, the decedent continued to operate the properties as if they were owned by her sole proprietorship, Shell Properties; continued the Shell Properties bank account to deposit partnership income; and continued to execute leases and contracts in the name of Sea Shell. The Tax Court held, on these facts, that the family limited partnership should be disregarded for estate tax purposes.

In a more recent case, **Estate of Thompson**, the Court held that the transfer was includible under § 2036(a) because the decedent contributed almost all his property to the family limited partnership, and the partnership continued to distribute funds to Mr. Thompson after formation to enable him to continue his lifestyle, including the making of annual exclusion gifts. One of the family limited partnerships loaned money to family members, who made interest payments late or not at all, and who had their loans reamortized.

The Tax Court concluded Mr. Thompson had an implied agreement to receive the income from the partnership as long as he lived, even though he lived only two years after formation of the partnership.

Estate of Thompson was recently affirmed on appeal in the Third Circuit, **Turner v. Commissioner**, 382 F.3rd 367 (3rd Cir. 9-1-2004). The Third Circuit stated that a diminution of value did not automatically rule out an "adequate and full consideration" exception for purposes of § 2036, but that in family limited partnerships there was a "heightened scrutiny" of the actual substance of the transaction. The Third Circuit held that there was no adequate and full consideration exception under these facts, where the donor transferred marketable securities to two family limited partnerships, which did not operate legitimate businesses.

The Third Circuit acknowledged there was some economic activity in the Turner partnership; however, these transactions did not rise to the level of legitimate business operations. The "Lewisville properties" business activity was overwhelmed by the testamentary nature of the transfers and subsequent operation of the partnership.

Two cases, **Strangi** and **Kimbell**, have ignited a storm of controversy in the estate planning community.

At his death, Mr. Strangi owned a 99% interest in a family limited partnership, SFLP, which had been formed two months before death, and a 47% interest in Stranco, a family corporation which owned a 1% general partnership interest in SFLP. In the initial

opinion, the Tax Court refused to consider the § 2036 argument, because it was not raised timely. However, the Court indicated in dicta that § 2036 might apply where the decedent owned a general partnership interest sufficient to terminate the family limited partnership.

On appeal, the Fifth Circuit determined that the respondent's § 2036 argument was timely raised, and remanded the case for consideration of the argument. **Gulig v. Commissioner, 293 F.3rd 279, 2002-USTC Para 60,441 (5th Cir. 2002).**

On remand, Judge Cohen held that the respondent showed by a preponderance of the evidence that Mr. Strangi retained the right to the income from, and the economic enjoyment of the mostly passive assets transferred to SFLP. Respondent had the burden of proof since the statutory notice failed to raise the § 2036 issue. The reasons enumerated by Judge Cohen were:

- Mr. Strangi transferred 98% of his assets to the family limited partnership;
- Mr. Strangi continued to live in the residence after he contributed it to the partnership;
- The pro rata distributions to Stranco were de minimis;
- The partnership expended funds in response to a need from Mr. Strangi or his estate, such as paying for funeral expenses, nursing care, estate taxes, and for back surgery for a nursing aide; and
- Mr. Strangi retained the income through his Power of Attorney, Mr. Gulig.

Further, after holding that § 2036(a)(1) applied to the transaction, Judge Cohen also held that § 2036(a)(2) applied to the transaction, as well.

Section 2036(a)(2) provides inclusion in the estate of any transfer for which the decedent retained during life the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from.

Since Mr. Strangi retained the right to revoke the partnership agreement and accelerate the present enjoyment of the assets, the decedent retained a right to designate the persons that would enjoy the property, thus causing inclusion under 2036(a)(2).

The Tax Court distinguished the holding in **U.S. v. Byrum, 408 U.S. 125 (1972), rehearing denied 409 U.S. 898 (1972)**, where the Supreme Court held that management powers subject to the business world were not within the contemplation of § 2036(a)(2), since here, the decedent's powers went beyond mere management, since there were no operating businesses, no independent trustees, and no fiduciary duties to third parties.

In summary, the facts in **Strangi** that led to an application of § 2036 were:

- A majority of the decedent's assets were transferred to the family limited partnership;
- The decedent continued to occupy the transferred residence;
- Personal and entity assets were commingled;
- There were disproportionate distributions of partnership assets for personal purposes of the decedent; and
- The family limited partnership had testamentary characteristics.

However, in another hotly debated decision, **Kimbell v. Commissioner**, an appeal of a Texas District Court granting a motion for summary judgment in favor of the respondent, the Fifth Circuit held that Mrs. Kimbell's transfer of assets to a family limited partnership was not includible under § 2036(a), because the evidence showed that the "bona fide sale for adequate and full consideration" exception to § 2036(a) applied.

Mrs. Kimbell had formed a family limited partnership in January 1998, with \$2.5 million in assets, transferring a 99% limited partnership interest to her revocable trust, and a 1% general partnership interest to a corporation, which was held 25% by decedent's son, 25% by decedent's daughter-in-law, and 50% by the trust. Decedent, who retained \$450,000 outside the partnership, thus owned 99.5% of the family limited partnership. Mrs. Kimbell died two months later, at age 96.

In upholding the respondent's motion for summary judgment, the Northern District of Texas found, as a matter of law, that § 2036 applied to the transfer (even though there was no gift), and a transfer of assets for a limited partnership interest is not a bona fide sale.

On appeal, the Fifth Circuit reversed the District Court. In making its determination, the Court relied upon the following:

- Whether the interest credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership;
- Whether the assets contributed by each partner to the partnership were properly contributed to the respective capital accounts of the partnership; and
- Whether on termination or dissolution of the partnership the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

The Fifth Circuit held that these tests were met under the uncontroverted facts, citing the following:

- Mrs. Kimbell retained sufficient assets outside the partnership for her own purposes;

- The partnership formalities were satisfied and the assets contributed to the partnership were actually assigned to the partnership; and
- The assets contributed to the partnership included working oil and gas interests.

In two very recent Tax Court decisions, the Court articulated another test for the existence of the “bona fide sale” exception to § 2036: the business purpose test; that is, whether the transfer of the property was made for a legitimate nontax purpose. This test was first enunciated in **Bongard, 124 T.C. No. 8 (2005)** and again addressed in **Bigelow, T. C. Memo. 2005-65**.

In **Bongard**, the taxpayer created an irrevocable trust (called the “ISA Trust”), funded with shares of stock in his closely held corporation, Empak, in 1980. On December 28, 1996, the taxpayer formed WCB Holdings, and he and the ISA Trust transferred their Empak stock to WCB in exchange for Class A governance (voting) units, Class A financial units, Class B governance units, and Class B financial units. The transfer was proportionate to their stock ownership.

On December 29, 1996, the taxpayer and ISA Trust created the Bongard Family Limited Partnership. Mr. Bongard transferred all his WCB Class B governance and financial units to the Bongard Family Limited Partnership (“BFLP”) in exchange for a 99% limited partnership interest. ISA Trust transferred Class B WCB units in exchange for a 1% general partnership interest. The exchange was proportionate to the partners’ interests.

On December 10, 1997, the taxpayer gave his wife a 7.72% interest in BFLP. On November 16, 1998, Mr. Bongard died suddenly at the age of 58.

The Government argued the Empak stock transferred to WCB was includible in the gross estate under §§ 2035, 2036(a), and 2036(b). The taxpayer argued the transfer was not includible under the bona fide sale exception to § 2036.

The Court held the first transfer of Empak to WCB met the bona fide sale exception, but the second transfer of WCB to BFLP did not. The Court stated that part of the “bona fide sale” test was whether there was a bona fide nontax reason for creating the family limited partnership. Although the taxpayer argued several nontax reasons for forming BFLP, such as creditor protection, ease of giving, and opportunity to give children investment experience, the Court did not accept those reasons. The Tax Court emphasized that BFLP never diversified its assets during decedent’s life, never had an investment plan, and never functioned as a business enterprise or otherwise had any meaningful economic activity.

There were several dissents; most notably arguing that the “bona fide nontax reason” test should not be a part of the bona fide sale exception to § 2036; however, it appears that the Tax Court has accepted the existence of this test in **Bigelow**, decided in March, 2005.

In **Bigelow**, the decedent owned property which she transferred to a family limited partnership at the age of 85, after she suffered a stroke and moved to an assisted living residence. She did not retain enough assets to pay for her living expenses, and, in fact, her son, who was executor and attorney in fact, made 40 transfers between the partnership and her trust to pay for living expenses. The Court found that there was an implied agreement for use of the assets during the decedent's lifetime, and included the assets in the estate under § 2036.

In deciding whether the transfer of the decedent's property to the family limited partnership was a bona fide sale, the Court held, citing **Bongard**, that the sale must be made for a legitimate nontax purpose. The Court found that the transaction was not made in good faith, and so the bona fide sale exception did not apply.

In the **Korby** cases, the Tax Court held that there was an implied agreement for the family limited partnership to support the decedents during their lifetime, where the decedent's living trust (the general partner of the family limited partnership), paid nursing home expenses, claiming they were management expenses.

In the **Schutt** case, the primary issue was whether the fair market value of stock the decedent had contributed through a revocable trust into two business trusts was includable in his gross estate. The Tax Court found for the petitioners in this case, determining that the transfers to the business trusts were bona fide sales for adequate and full consideration for purposes of §§ 2036(a) and 2038. Petitioners had contended in this case, that the predominant motive for the creation of the business trusts was to perpetuate the decedent's buy and hold investment philosophy rather than estate tax savings.

Issue 3

Whether there is an indirect gift of the underlying assets, rather than the family limited partnership interests, where the transfers of assets to the family limited partnership (funding) occurred either before, at the same time, or after the gifts of the limited partnership interests were made to family members.

Compliance Position

Under current case law, transfers of assets to a family limited partnership after transfers of limited partnership interests were made to family members are indirect gifts and subject to the gift tax provisions of the Internal Revenue Code.

Taxpayer's Position

Transfers of assets to a family limited partnership after transfers of the limited partnership interests themselves are actually transfers of partnerships interests.

Discussion

In the case of **Shepherd v. Commissioner**, 115 T.C. 376 (2000), **aff'd** 283 F.3d 1258 (11th Cir. 2002), **rehearing, en banc, denied** 2002 U.S. App. LEXIS 14147 (2002), the Eleventh Circuit upheld a Tax Court decision holding that Mr. Shepherd made an indirect gift to his children where he created a family limited partnership on August 1, 1991, transferring two 25% interests in same to his two children. Thereafter, on August 30, 1991, the taxpayer conveyed by recorded deed a fee simple interest in timberland, and on September 9, 1991, the taxpayer conveyed bank stock to the partnership. The Tax Court determined that the actual gift was a gift of land, and valued the gift as such, without discounting the transfer as a partnership interest.

This same result was reached in **Senda v. Commissioner**, T.C. Memo. 2004-160, **aff'd** 2006 U.S. App. LEXIS 254 (8th Cir. 2006), where the taxpayer formed a family limited partnership in 1996, but did not fund it until 1998. The children's transfers were purportedly held for them in trust, but there was no written trust agreement. Further, the certificates of limited partnership reflecting the transfers were not prepared and signed until several years after the transfer.

Quoting **Shepherd**, where the contributions were allocated pro rata to the noncontributing partners, the Tax Court held that the gifts were indirect transfers, since it was unclear whether the taxpayer's contributions of stock to the family limited partnership were ever reflected in their capital accounts. The Court noted that the funding and gifting were integrated and in effect simultaneous. The Circuit Court agreed that these were integrated steps of a single transaction (the step-transaction doctrine).

Issue 4

Whether an accuracy-related penalty under I.R.C. § 6662 is applicable to any portion of the deficiency.

I.R.C. § 6662 imposes an accuracy-related penalty of 20% of the underpayment of tax attributable to, among other things: (1) negligence or disregard of rules or regulations and (2) any substantial valuation understatement. A penalty of 40% applies if the underpayment is attributable to a gross valuation understatement. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation understatement), even if that portion of the underpayment is attributable to more than one type of misconduct

(e.g., negligence and substantial valuation understatement). See **DHL Corp. v. Commissioner, T.C. Memo. 1998-461. aff'd in part and rev'd on other grounds, remanded, 285 F.3d 1210 (9th Cir. 2002)** (either the 40 percent accuracy-related penalty attributable to a gross valuation misstatement under section 6662(h) or the 20 percent accuracy-related penalty attributable to negligence is applicable). The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. I.R.C. § 6662(b).

The penalty applies only when a tax return is filed. I.R.C. § 6664 (b). There is an exception to the imposition of accuracy related penalties where there was reasonable cause for, and the taxpayer acted in good faith with respect to, such understatement. I.R.C. § 6664 (c)(1).

Compliance Position

In certain family limited partnership cases where the valuation discounts claimed are egregious, Compliance may argue that a penalty applies pursuant to § 6662(g) or § 6662(h)(2)(C). If there is evidence of negligence, Compliance also may conclude that a penalty applies, pursuant to § 6662(c).

If multiple provisions of § 6662 are raised, normally Compliance lists substantial or gross valuation understatement as its primary position and negligence as its alternative position.

Taxpayer's Position

Taxpayers typically argue that no accuracy related penalty applies due to the reasonable cause exceptions provided for in the law and regulations.

Discussion

Whether accuracy related penalties apply to cases involving family limited partnerships must be determined on a case-by-case basis depending on the specific facts and circumstances of the taxpayer. The application of any penalty must be based upon a comparison of the facts developed with the legal standard for the application of the penalty. Compliance should accordingly ensure that the scope of their factual development encompasses those matters relevant to any penalties proposed.

Negligence

I.R.C. § 6662(c) provides for a 20% penalty for negligence when the taxpayer fails to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return.

See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See ***Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964); *Neely v. Commissioner*, 85 T.C. 934, 947 (1985)**. Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. § 1.6662-3(c). A reasonable basis is a relatively high standard of tax reporting, one significantly higher than not frivolous or not patently improper. Thus, the reasonable basis standard is not satisfied by a return position that is merely arguable or colorable. Conversely, under Treas. Reg. § 1.6662-3(b)(3), a return position is reasonable where it is based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2).

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the IRS and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence in determining the correctness of a position taken on its return that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances demonstrating a substantial deviation from the standard of conduct observed by a reasonable person. Additionally, disregard of the rules and regulations is "intentional" where the taxpayer has knowledge of the rule or regulation that it disregards. Treas. Reg. § 1.6662-3(b)(2).

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations); and (2), in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. See Rev. Proc. 2002-66, 2002-2 C.B. 724.

Substantial or Gross Estate or Gift Tax Valuation Understatement

I.R.C. § 6662(g) provides for a penalty equal to 20% of the underpayment of estate or gift tax attributable to a substantial valuation understatement.¹ There is a substantial estate or gift tax understatement if the value of any property claimed on the return of tax imposed by Subtitle B is 50% or less of the amount determined to be the correct amount of such valuation. I.R.C. § 6662(g)(1). I.R.C. § 6662(h)(2)(C) provides for a penalty equal to 40% of the underpayment of estate or gift tax attributable to a gross valuation understatement. There is a gross valuation misstatement if the value of any property claimed on a return is 25% or less of the amount determined to be the correct amount of such valuation. In both instances, the portion of the underpayment attributable to the valuation understatement must exceed \$5,000.

The determination of whether the percentage and dollar thresholds for a substantial or gross valuation misstatement have been reached is made on a property by property basis. The understatement percentage is calculated by dividing the value of the property reported on the return by the corrected value of the property. See I.R.M. 20.1.5.11.2. Treas. Reg. § 1.6664-3 describes the ordering rules for determining the underpayment on which the penalty is imposed.

The Reasonable Cause Exception

The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1) and (f)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. See Treas. Reg. § 1.6664-4(b).

In the case of a family limited partnership, the taxpayer will often have relied upon the advice of an attorney, accountant, appraiser, or a combination thereof, for assistance in establishing and funding the family limited partnership. Accordingly, in the majority of cases, the relevant inquiry for the imposition of any accuracy related penalty is whether the taxpayer's reliance was reasonable and in good faith.

All relevant facts, including the nature of the transaction or investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith. Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the

¹ For purposes of I.R.C. § 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. I.R.C. § 6664(a).

experience, knowledge, sophistication, and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, is relevant in deciding whether the taxpayer acted with reasonable cause. See **Kees v. Commissioner**, **T.C. Memo. 1999-41**. If the taxpayer is misguided, unsophisticated in tax law, and acts in good faith, a penalty is not warranted. See **Collins v. Commissioner**, **857 F.2d 1383, 1386 (9th Cir. 1988)**.

In order for reliance on a tax advisor to constitute reasonable cause, the taxpayer must have acted in good faith and made full disclosure of all relevant facts to the advisor. In **Long Term Capital Holdings v. United States**, **330 F. Supp.2d 122, 199 (D. Conn. 2004)**, **aff'd 2005 U.S. App. LEXIS 20988 (2005)**, the Court relied upon the following points in making its determination that it did not rely in good faith upon its professional opinions:

- There was no corroborative evidence to support the existence, timing, and nature of the advice;
- The written advice was not received timely, before the tax return was filed;
- There were no substantive citations to relevant legal authority;
- The opinion did not contain reasonable legal assumptions; and
- The clarity, specificity, and legal depth of the analysis were lacking.

In one of the most comprehensive analysis of reasonable cause and reliance on a tax advisor, **Neonatology Associates P.A. v. Commissioner**, **115 T.C. 43, 99 (2000)**, **motion granted 293 F.3d 128 (3d Cir. 2002)**, **aff'd, 299 F.3d 221 (3d Cir. 2002)**, the Tax Court articulated a three-prong test to establish a reasonable cause defense: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the adviser's judgment.

While case law involving the reliance of a tax advisor in the estate and gift context is rather limited, in **Estate of Monroe v. Commissioner**, **104 T.C. 352 (1995) rev'd in part remanded in part 124 F.3d 699 (5th Cir. 1997)**, the Tax Court held reliance on a qualified adviser did not constitute reasonable cause where the estate failed to advise the accountants of certain cash gifts to beneficiaries that equaled renounced bequests. See also **Estate of Sylvia Goldman**, **71 T.C. Memo. 1996-29** (I.R.C. § 6662 penalty upheld where it was not shown that the accountant was furnished with all the information necessary to prepare an accurate return). In contrast, in **Streber v. Commissioner**, **138 F.3d 216 (5th Cir. 1998)**, **citing Reser v. Commissioner**, **112 F.3d 1258, 1251 (5th Cir 1995)**, the Fifth Circuit reversed the Tax Court and held that two daughters reasonably relied upon the advice of a tax professional in connection with a transfer by their father of two \$2,000,000 promissory notes in 1981, which were paid off in 1985. The daughters did not report capital gain on the transaction, arguing that they consulted an "advisor" who advised that the notes were neither

income nor a gift. At the time of the transaction, the daughters were teenagers, and their lack of sophistication appears to have been a factor.

Factors to be considered in determining reasonable cause and good faith with respect to an appraisal include: (1) the methodology and assumptions underlying the appraisal; (2) the appraised value; (3) the circumstances under which the appraisal was attained; and (4) the appraiser's relationship to the taxpayer. Treas. Reg. § 1.16664-4(b)(1). In **Estate of Schauerhamer, 73 T.C.Memo. 2855 (1997)**, the Court held that the taxpayer reasonably relied upon the appraiser, although there was no significant discussion of the details of the appraisal or the methods used by the appraiser. The complete failure to have an appraisal evidences a lack of reasonable cause and good faith. See **Estate of H.A. True, Jr., Deceased, H.A. True, III, Personal Representative, and Jean D. True et. al. v. Commissioner, T.C. Memo. 2001-167**, (Tax Court upheld the penalty on the understatement of tax attributable to substantially and grossly undervalued assets because the executors did not engage the services of an appraiser).

SETTLEMENT GUIDELINES

General Comments – Duty of Consistency

In a recent case, **Janis v. Commissioner, T.C. Memo. 2004-117**, the taxpayer used the undiscounted basis for determining cost of goods sold in an art inventory, even though a heavily discounted basis was used when valuing the art inventory for estate tax purposes. The Tax Court held that, under a duty of consistency, the taxpayer was required to use the same basis for estate and income tax reporting purposes. The three tests of the taxpayer's duty of consistency were: (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations.

Settlement Guidelines for Issue 1

With the three decisions of **McCord**, **Lappo**, and **Peracchio**, it is obvious that the Tax Court has become increasingly sophisticated in its analysis and valuation of passive asset family limited partnership interests.

The Appeals Officer should carefully review the taxpayer's appraisal for comparability and such factors as (among others):

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While these factors will vary with the risk inherent in the type of investment and overall
market forces,
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For those family limited partnerships consisting mostly of cash or cash equivalents,

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While this is contra to the recent Tax Court decision of **Estate of Webster E. Kelley v. Commissioner**, (where the Court allowed a minority interest discount of 12% and a marketability discount of 23% on a family limited partnership funded with cash and certificates of deposit), that case can be strongly criticized because both sides used closed-end securities funds as comparable to cash. Money Market funds would be a more appropriate comparable. As previously stated, this case is an anomaly for several reasons both factually and administrative, and should not be considered in determining the minority and marketability interest discounts applicable for similarly funded family limited partnerships.

With respect to the lack of marketability discount, the studies relied upon by the
appraiser should be carefully considered, especially with regard to how current the data
is used in the report.

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In analyzing the hazards of litigation for the Government in §§ 2036(a)(1), 2036(a)(2), or § 2038 cases, the Appeals Officer should consider the following nonexclusive list of factors:

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The answers to these, and other factual questions, will determine the strengths and weaknesses of the Government's case, and enable the Appeals Officer to weigh the hazards of litigation.

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In cases with facts similar to **Shepherd** and **Senda**, where the timing of the transfers of partnership interests and asset transfers is at issue,

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Settlement Guidelines for Issue 4

The IRS has adopted a policy with respect to penalties that applies to all functions. Penalties must be considered on their own merits. It is never appropriate to “trade” any amount of an appropriate penalty for a concession by the taxpayer of the underlying issue.

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Based upon the reasoning in the court cases cited above, the absence of an appraisal, or an unreasonable reliance on an appraisal that takes an egregious discount, the taxpayer may be subject to a penalty under § 6662,

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The Appeals Officer, in making a hazards of litigation determination of the penalty, should carefully evaluate the taxpayer’s reliance on the professional appraisal for:

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The application of the § 6662 penalty may be seen in the following examples. For purposes of these examples, it is assumed that the family limited partnership is recognized as a valid partnership and is not deemed to be a sham.

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Example #1: The taxpayers, husband and wife, form a family limited partnership and transfer miscellaneous assets into a family limited partnership. Pursuant to certain tax advice from their estate planning attorney, the taxpayers make certain gift transfers to their children. All the formalities of a partnership are observed. An appraisal is conducted by a member of the taxpayers’ family, and without citing any methodology, the appraiser provides his opinion that the family limited partnership interests should be discounted by because of a lack of marketability and minority interest. An appraiser for the Government is retained, who opines that the applicable discount should be

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Example #2: The taxpayers, husband and wife, contribute cash and certificates of deposit to a family limited partnership classified as an investment company. Pursuant to advice from a certified public accountant, certain gift transfers are made to the taxpayers’ grandchildren. All the formalities of a partnership are observed. An

independent appraiser is retained and, using an IPO approach which compares the private-market price of shares sold before a company goes public with the public-market price obtained in the initial public offering of the shares, the appraiser concludes that a lack of marketability discount of applies. An appraiser for the Government, using a restricted stock approach which compares the private-market price of restricted shares of public companies with their coeval public-market price, concludes that a lack of marketability discount applies.

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Example #3: Pursuant to advice from their tax attorney, the taxpayers, husband and wife, form a family limited partnership consisting of 100 units of ownership and convey real property and financial assets to the partnership. The partnership makes certain financial investments, including significant investments in bonds and treasury notes. All of the formalities of a partnership are observed. An independent appraiser is retained. Using well-recognized methodology, the appraiser discounts the value of the gifts based on (1) a portfolio discount which

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