

SAN ANTONIO ESTATE PLANNING COUNCIL

**CURRENT STATUS OF IRS EXAMINATIONS
OF ESTATE AND GIFT TAX RETURNS**

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CURRENT STATUS OF IRS EXAMINATIONS OF ESTATE AND GIFT TAX RETURNS

I. INTERESTING FACTS REGARDING ESTATE TAXES.

A. Repeal. In 2001 the Economic Growth and Tax Relief and Reconciliation Act (“EGTRRA”) was passed which repealed the estate and generation-skipping transfer tax -- effective ten years hence on January 1, 2010. Until that time, we have lowering effective rates and rising exemptions as follows:

Year of Gift or Death	Gift Tax Exemption	Estate and Gift Tax Exemption	Top Estate and GST Tax Rate
2005	\$1,000,000	\$1,500,000	47%
2006	\$1,000,000	\$2,000,000	46%
2007-2008	\$1,000,000	\$2,000,000	45%
2009	\$1,000,000	\$3,500,000	45%
2010	\$1,000,000	Estate Tax Repeal	0
2011 & Thereafter	\$1,000,000	\$1,000,000	55/60%

B. Current Outlook. The estate tax continues to be a political football and we will only know the final outcome when it actually occurs. Some recent “developments” include:

- HR 436
- President’s Proposed Budget
- Congressional Budget Process
- Proposed 1 year freeze at 2009 levels
- Proposed 5 year freeze at 2009 levels
- Proposed permanent freeze at 2009 levels
- Reunification of gift and estate tax exemptions
- Portability of exemptions
- Closing perceived loophole of discount on closely held entities

C. New IRS Filing Statistics. The IRS has recently compiled and released a comprehensive statistics for federal gift and estate tax returns for decedents dying in 2004, the latest year that such statistics are available. The full report may be found on the IRS website at <http://www.irs.gov/taxstats/indtaxstats> . The following are a few of the findings:

- There were 42,239 total 2004 decedents with estates over \$1.5 million. This represents 1.8% of all U.S. adult deaths;
 - o 30,840 of those estates were between \$1.5 and \$3.5 million
 - o 11,399 were over \$3.5 million;

- The total Gross Estate for those 42,239 Returns was \$186 billion
 - o \$67 billion for estates between \$1.5 and \$3.5 billion
 - o \$19.5 billion for estates between \$3.5 and \$5 billion
 - o \$99.5 billion for estates over \$5 million

- There were 1,513 estates reporting a Family Limited Partnership (or “FLP”). This represents 3.6% of all Returns. The percentage of 2001 decedents reporting FLPs was only 1.7%;
 - o In estates over \$20 million, 12.4% of them reported an FLP;
 - o Interestingly, of the total estates reporting an FLP, 53% reflected a tax liability, while 47% reported no tax liability;

 - o There was \$3.5 billion in discounts taken for the FLP interests. This represents 54.2% of all valuation discounts taken on returns;

 - o The average discount taken on FLP interests was 32%;

D. Charitable Deductions and Estate Tax. According to the Congressional Budget Office, the Estate Tax encourages wealthy individuals to donate more to charity since the estate tax liability is reduced by charitable gifts at death. The CBO estimated that charity contributions would drop by \$13 to \$25 billion if there were no Estate Tax. The new IRS statistics would seem to support this estimate as the percentage of estates with charitable bequests increases steadily with the size of the estate and the charitable bequest as a percentage of the estate also increases with the size of the estate. The following are a few more findings of the recent IRS report for 2004 decedents:

- Of the 2004 returns filed 20.6% reported some charitable bequest;

- There were gross charitable bequests of \$17.8 billion which was 9.6% of the combined gross estate of all 2004 returns;

- 16% of estates of less than \$2 million had charitable bequests, and the amount of the charitable bequests as a percentage of the gross estate was 3.8%;

- 44.2% of estates over 20 million had charitable bequests, and the amount of the charitable bequests as a percentage of the gross estate was 20%.

II. IRS ACTIVITY LEVELS IN TRANSFER TAX ARENA.

A. Audit Levels.

1. Estate Tax Returns (Form 706) – Estates are classified by gross estate. For fiscal year 2007, 59,978 returns were filed, 4,616 audited for a coverage percentage of 7.7%.

a. Gross estate below \$1,500,000. (This category was eliminated in 2006.)

(1)	Pre-reorganization:	1989 audit coverage	17.93%
		1994 audit coverage	8.2%
		1996 audit coverage	7.85%
		2000 audit coverage	3.40%
		2001 audit coverage	2.76%
		2002 audit coverage	2.19%
		2003 audit coverage	2.61%
		2004 audit coverage	4.93%

(2) Fiscal year 2005:

(a) Returns in this class: 37,998;

(b) Audits performed: 533;

(c) Fiscal year 2005 audit coverage 1.40%.

b. Gross estate below \$5,000,000. (2007 FY stats only track gross estates below \$5,000,000).

(1)	Pre-reorganization:	1989 audit coverage	29.70%
		1994 audit coverage	22.78%
		1996 audit coverage	21.42%
		2000 audit coverage	8.92%
		2001 audit coverage	7.76%
		2002 audit coverage	7.28%
		2003 audit coverage	7.40%
		2004 audit coverage	6.20%
		2005 audit coverage	12.79%
	(1.5 to 5.0 million)	2006 audit coverage	7.82%

(2) Fiscal year 2007:

(a) Returns in this class: 51,940;

(b) Audits performed: 3,017;

(c) Fiscal year 2007 audit coverage 5.8%.

c. Gross estate above \$5,000,000.

(1)	Pre-reorganization:	1989 audit coverage	51.30%
		1994 audit coverage	48.00%
		1996 audit coverage	49.33%
		2000 audit coverage	27.81%
		2001 audit coverage	28.87%
		2002 audit coverage	26.93%

2003 audit coverage	27.48%
2004 audit coverage	26.57%
2005 audit coverage	28.12%
2006 audit coverage	23.45%

(2) Fiscal year 2007:

- (a) Returns in this class: 8,038;
- (b) Audits performed: 1,599;
- (c) Fiscal year 2007 audit coverage 19.9%.

2. Gift Tax Returns (Form 709) – for Fiscal Year 2007:

- a. 264,315 returns filed
- b. 1,490 audits performed for a coverage percentage of .6% (.65% for 2001; .63% for 2002; .66% for 2003; .69% for 2004; .81% for 2005; .77% for 2006)

B. Reduction in Transfer Tax Examinations. In July 2006 the IRS announced that it was eliminating some 157 Estate and Gift Tax auditors (out of a total of 345), plus 17 support personnel.

- 1. This was a surprise to line agents and middle managers and is aimed at the more senior agents. [The IRS has said before that these were the most revenue productive of its agents at \$2,200/hour.]
- 2. Note the positions are being terminated; so the agents will not be transferred to other areas.
 - a. This is said to be a result of civil service rules and the IRS claims it sought an exception to avoid termination of the agents.
 - b. IRS agents claim the Service did not try very hard to get an exception.
- 3. It is happening fast; before year end 2006.
- 4. The Service is pushing senior agents to take early retirement and is offering a \$25,000 bonus.
- 5. Money saved by this action is supposed to be used to hire additional income tax auditors.

C. Issue Selection.

1. Valuation of fractional equity ownership of pass-through entities; i.e., Family Limited Partnerships (FLPs) and closely-held corporations.
 - a. Valuation Issues
 - b. Inclusion Issues; e.g., Section 2036
2. Valuation issues of other assets; e.g., timber, mineral rights, undivided ownership of land.
3. Administrative Expenses.
4. Annuity transactions.

III. WORKING WITH THE EXAMINING AGENT.

A. A word about the Estate/Gift Revenue Agent. The typical Estate/Gift Revenue Agent is a thoroughly trained and experienced individual who varies substantially from IRS agents in other practice areas. Significant differences include:

1. They are almost always attorneys. You should note that they typically sign correspondence in that capacity and their audit discovery requests often are phrased more like pre-litigation documents.
2. They are very experienced. The IRS has certain pockets of expertise where they have been able to retain a depth of personnel despite the turmoil of the reorganization. Estate and Gift are such areas. Not only will agents be familiar with the operative law, but often have worked in a given geographic area long enough to be familiar with locally prominent individuals/families.
3. They are dramatically overworked.
 - a. Examination of a large, complex estate is substantially more time consuming than an income tax audit of a similarly sized economic unit. The transactions are more complex, they are often unique (so there is no ability to rely on internal control) and with a comprehensive estate plan the agent may have to look at many years.
 - b. The IRS has been unable to maintain realistic staffing levels in Estate and Gift. There are several reasons for this:

- (1) Since these agents are more highly qualified there are both fewer potential candidates and more competition for those that exist.
 - (2) The reorganization somewhat marginalized Estate and Gift, making it a less desirable career path and siphoning off talent (primarily experienced IRS Area Council attorneys, not examining agents).
 - (3) The national discussion about repealing/minimizing transfer taxes has been a disincentive to attracting or retaining resources in Estate and Gift.
- c.** There are relatively few Estate and Gift tax agents.
- 4.** They have good management.
 - 5.** Many agents have an attitude about discounting. Discounting in the context of closely held pass-through entities does not seem like an issue that would produce an emotional response, but it does for many agents. Aside from dramatically minimizing transfer taxes, many agents contend that it fundamentally undermines the estate and gift taxes. While we may disagree it is important to understand both their viewpoint and the depth of their antipathy.
 - a.** Their argument: two similarly situated taxpayers, one with an aggressive FLP, the other without – resulting in vastly different estate taxes for what the IRS deems to be equal economic situations. Response: it has always been true that taxpayers with good estate planning can minimize tax; so this complaint is not unique to discounting. IRS counter: yes, but discounting cuts the tax by too much and most FLPs are constructs.
 - b.** However you evaluate the IRS' position, understand that the agent's attitude will influence the depth of the audit, issue selection and the spread of arguments raised. Practically, this tends to work in the taxpayer's favor since it means the IRS often reiterates emotionally charged arguments that have been rejected by the courts and/or focus on discounting issues and missing other soft spots on the 709.
 - 6.** They have not been given good support in issue development. A recurring problem in this area is that National Office has pushed for the development of specific issues, especially in the FLP arena, and then failed to carry through with securing precedent resolving those issues. This has left many agents with a simmering resentment; as they exert

themselves to develop issues, only to see the cases shift of be “given away” in the appellate/litigation process.

B. Timing. The combination of too few agents and too many cases is compounded by the peculiarity that the statute of limitations on assessment cannot be extended by agreement for Estate taxes. This means that while cases may be assigned to an agent relatively quickly, that they may then sit largely unworked for awhile, with a flurry of activity as the three-year statute of limitations approaches. This is frustrating to the Estate (especially the heirs) and probably irritating to the agents.

C. Issue Development. Some agents, conscious of the timing crunch described above, have developed a new tactic involving exhaustive Information Document Requests (IDRs). An example is attached to this outline as an exhibit.

1. Exhaustive IDRs shift the burden of preparing the audit to the taxpayer.
2. It is not unusual for a taxpayer to respond to a burdensome IDR only to have the IRS go silent for extended periods.
3. While IDRs have no force of law, they cannot be disregarded.
 - a. Failure to respond can lead to issuance of a summons.
 - b. Circular 230 proscribes contemptuous disregard.
4. Note that agents are using IDRs like traditional discovery; to limit issues and define positions. For example, requests to list every business purpose for formation of an FLP, etc.

D. Working with the agent.

1. There was a time, recently, when the chance of resolving a FLP case with an examining Estate tax agent was so remote that I would have advised against a significant expenditure of time/resources. That has changed, and at least some pass-through valuation issues are being resolved at that level. My suggestion is that a good faith attempt at settlement be attempted, but that the representative be watchful of a hardening of attitude that will make compromise impossible.
2. Work to narrow the IDRs.
3. Work to narrow the number of issues moving forward.

E. Charitable Deductions and Estate Tax. According to the Congressional Budget Office, the Estate Tax encourages wealthy individuals to donate more to charity since the estate tax liability is reduced by charitable gifts at death. The CBO estimated that charity contributions would

drop by \$13 to \$25 billion if there were no Estate Tax. The new IRS statistics would seem to support this estimate as the percentage of estates with charitable bequests increases steadily with the size of the estate and the charitable bequest as a percentage of the estate also increases with the size of the estate. The following are a few more findings of the recent IRS report for 2004 decedents:

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- There were gross charitable bequests of \$17.8 billion which was 9.6% of the combined gross estate of all 2004 returns;
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IV. SO WHAT HAPPENS IF YOU DO NOT WORK IT OUT WITH THE AGENT?

A. The convergence of hot issues, big dollars, and the impending statute of limitations often produces a high-pressure situation in which the agent is demanding concessions or threatening to move the case forward unagreed, often with a larger potential deficiency resulting from “undoing” interim compromises on agreed issues. Do not give into this pressure if you believe your client’s position has merit.

B. Appellate Review. Ideally an unagreed agent’s report leads to the issuance of a 30-day letter allowing the taxpayer to file a protest and secure an appellate conference. In reality, the crunch of the statute of limitations often eliminates that option because there simply is not enough time left to circuit the case through appeals. Normally it takes about 270 days for the appellate process. As such many unagreed transfer tax cases move directly from the agent to the issuance of a Statutory Notice of Deficiency.

C. The Stat Notice May Be Scary. Prepare yourself and your client for the probability that the Stat Notice will be for a higher amount than was being discussed with the agent. Typically the agent writes up all issues, including those in which a tentative concession has been arranged, under the theory that without a global settlement everything is back in play.

D. Options. In reality the issuance of a Stat Notice gives the taxpayer meaningful options to contest an unagreed case. For example:

1. File with the United States Tax Court. While a full discussion of this is beyond this outline, the most significant points include:
 - a. filing is relatively simple, but must be done within strict time limits;
 - b. after filing, the case moves to the Appellate Division – the same group that would have heard a protest if a 30-day letter had been

issued, where there is an opportunity for an appellate officer to reevaluate the case and negotiate a settlement; and

- c. the overwhelming majority of all Tax Court cases settle without trial, and in fact, transfer tax valuation cases are particularly good candidates for settlement.

2. Pay and file a refund claim.
3. Refund litigation.

V. FREEZE TECHNIQUES FOR NEW PLANNING ENVIRONMENT.

Valuation discounts for gift and estate tax planning associated with interests in closely held entities (family-owned corporations, LLCs and family limited partnerships) have long been a cornerstone in family wealth transfer planning. HR 436, proposed during in January 2009, proposes to change all of this. As has been readily documented, the IRS has lost significant court battles, which have held without equivocation that standard valuation discounts, such as discounts for lack of control and minority interests, are clearly applicable to closely held entities (see *Kimbel vs. Commissioner*, and *Adams v. Commissioner*).

The Bill's purpose is two-fold. First, it purports to reverse the estate tax repeal law passed in 2001 by freezing the exemption at \$3,500,000 and the gift and estate tax rate at 45 percent. This is the current law for 2009, and it also reflects the position taken by President Obama during the presidential election.

Secondly, the Bill purports to disallow any valuation discounts related to passive assets associated with a closely held entity. While the fate of this particular bill is uncertain, what is clear is the desire of the Congress to (1) ensure that a significant estate tax exists for the foreseeable future; and (2) reduce perceived loopholes in the current estate tax law associated with valuation discounts for closely-held entities.

From a planning perspective, therefore, practitioners and their clients should seriously consider wealth transfer planning that takes advantage of the current status of the law.

First, most valuation planning techniques involve the use of discounted closely-held interests in entities. The best example is a family limited partnership in which limited partnership interests may be transferred to the younger generation, thus taking advantage of valuation discounts to reduce the value of the associated gifts.

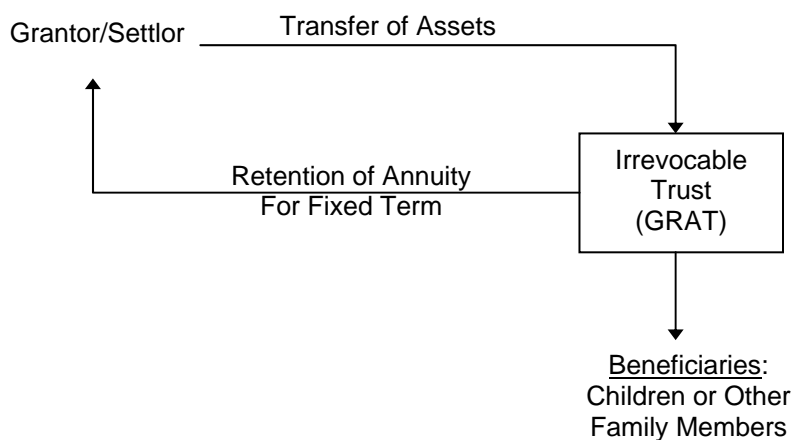
Secondly, the current economy has produced two effects which, when combined, create an extremely favorable environment for wealth transfer planning. First, interest rates are at a historically low point. [Note: A new notice provides supplements to the Code Sec. 7520 actuarial tables because the Code Sec. 7520 interest rate recently fell below 2.2%, which was the lowest interest rate under the preexisting tables. The notice furnishes extensions to the existing tables for interest rates below 2.2%. Notice 2009-18, 2009-10 IRB]. Additionally, property values are depressed. The combination of these two phenomena makes transfer planning

techniques such as grantor retained annuity trusts (or “GRATs”) and sales to intentionally defective grantor trusts (or “IDGTs”) quite favorable.

The specter of potentially losing the ability to discount closely held entities, along with the economic realities of low interest rates and depressed asset values, create a truly one-of-a-kind transfer tax planning environment.

This section will address three common estate planning freeze techniques and provide various planning ideas, as well as some practical planning tips, practitioners should consider when designing, implementing, and monitoring any of these techniques. In the current environment of low interest rates and depressed asset values, these techniques are even more effective to transfer wealth among families with reduced transfer tax costs.

A. GRAT. The Grantor Retained Annuity Trust (“GRAT”) is another popular and powerful estate freezing technique. In a GRAT, the grantor, transfers an interest in property to a trust and retains an interest in that property in the form of an annuity which meets certain requirements spelled out under Section 2702. The GRAT plan can be diagrammed as follows:



In determining the value of the gifted remainder interest, the value of the annuity interest retained by the grantor reduces the value of the transferred remainder interest. The grantor has flexibility and is able to set the term of the trust as well as the amount of the annuity. Upon formation of the GRAT, the grantor makes a gift of the actuarial value of the remainder interest in the property. The value of the remainder interest depends on the term of the trust, the applicable rate under Section 7520, and the amount of the annuity. The grantor has the flexibility to increase the amount of the annuity and/or increase the length of the term of the GRAT and this in turn will lower the value of the gifted remainder interest. The Section 7520 rate is the hurdle rate in which if the value of the assets transferred to the GRAT appreciate in excess of the Section 7520 rate, the GRAT will be successful. Moreover, the grantor must out live the term of the GRAT in order to avoid inclusion of any of the GRAT assets and the grantor’s gross estate. The grantor however, is in no worse of a position than if he had never created the GRAT. Thus, the only cost of a failed GRAT is the cost of establishing it (and perhaps an opportunity cost of foregoing other planning).

Post *Walton*, the gift of a GRAT can be “zeroed-out” by designing the GRAT so that the present value of the retained annuity interest is equal to the value of the assets contributed to the GRAT. In other words, a GRAT may now be structured to produce only a nominal gift on formation. Post *Walton*, the retained interest payable to a grantor’s estate is now a qualified interest. This allows practitioners to create a GRAT for a term of years and zero-out the GRAT utilizing the annuity factors applicable to a term of years instead of the shorter of a term or life. Thus, most GRATs should be for a term of years and not for life (causing estate inclusion) or the shorter of a term or life (causing a greater gift than necessary because there is always a chance the grantor could die during the term).

Section 2702 contains various requirements that are necessary to qualify the grantor retained interest as a qualified annuity interest. Some of those requirements are as follows:

Payments must be made not less frequently than annually:

- Annuity must be a fixed amount or a fraction of the initial value and may increase by no more than 20% annually;
- No additional contributions; and
- Prohibit commutation.

1. Transfer Tax Benefits Of GRAT.

a. Reduction of Transfer Tax Upon Initial Transfer.

A GRAT can significantly reduce transfer taxes upon the initial transfer of the assets. It is in the interest of the donor in any gratuitous transfer of property to reduce the value of the transferred property in order to reduce the applicable transfer taxes. One primary way a donor can do this is to transfer a future interest in the property while retaining a present interest.

In general, Section 2702 prohibits a reduction in the value for a retained interest within the family context, but the GRAT is a statutory exception to this general rule. As discussed above as long as the retained annuity is a qualified interest under Section 2702, then the value of the retained annuity interest reduces the value of the initial gift.

b. Use of a GRAT as an Estate Freezing Device.

After the donor creates the GRAT, the gift is complete. As a result of this completed gift, the value of the assets and all future appreciation on the assets to the extent they outperform the 7420 Rate has been removed from the donor’s estate, assuming of course the donor survives the GRAT term.

c. Estate Reduction Opportunity – Post GRAT Term.

At the end of the QPRT term the residence will pass to the remainder beneficiaries. Assuming the donor wishes to remain in the home, he must then pay the remainder beneficiaries fair market value rent. This provides the donor with an opportunity to make additional payments to the beneficiaries that will reduce the value of his taxable estate and, at the same time, transfer additional assets to the beneficiaries.

2. GRAT Planning Tips.

a. Use Short Term Rolling GRATs.

Studies show a grantor utilizing a series of short-term GRATs funded with publicly traded stocks is almost always more likely to succeed at transferring wealth and will most likely transfer more wealth than an identically funded long-term GRAT, regardless of the Section 7520 rate at the strategy's inception and even during times of market weakness. The one notable exception to this general rule is with respect to an illiquid, hard-to-value asset. This type of asset may be better in a long-term GRAT. The reason for this is the cost associated with frequent valuations.

There are two reasons why the rolling short-term GRAT is more successful than a single long-term GRAT: (1) More funds remain committed to the strategy over time (as opposed to a single long-term GRAT where annuity payments to the grantor reduce the funds each year) (2) The shorter time horizon (generally two years) in the rolling GRAT strategy addresses the volatility of the GRAT assets (i.e., minimizes the risk that a good investment performance in one year will be offset by poor investment performance in another year).

b. Use Graduated Annuity.

The Regulations permit increasing annuity payments of up to 20% per year. This is sometimes referred to as a “back-end loaded” GRAT. The advantage of using a back-end loaded GRAT is that the payments in the early years are smaller, enabling the GRAT more time to accumulate funds and delaying payments as long as possible. Of course, if one employs a short-term rolling GRAT strategy, the use of a back-end loaded GRAT is somewhat mitigated.

c. Use Separate GRAT for Each Asset.

In the event a GRAT does not go as planned and a particular asset transferred to a GRAT does not provide sufficient cash flow (together with the principal of the asset) to make all required annuity payments, the GRAT would simply terminate. If multiple assets are transferred to the same GRAT, these other assets would have to be utilized to make the required annuity payments. Thus, it is beneficial to use a separate GRAT for each individual asset so that high-performing investments will not be required to compensate for poor-performing assets.

d. Capping the GRAT.

A parent may have an asset that he or she believes might explode in value in the near future. This parent may be willing to transfer significant wealth to his or her children, but may not be willing to transfer too much wealth. In this case, a GRAT may be structured to provide that the first \$X of value at the close of the GRAT term would pass to the grantor's children (or trusts for their benefit), and that the value in excess of \$X would be returned to the grantor. In this particular example, if no gift exemption was utilized on the formation of the GRAT (i.e., the GRAT was zeroed-out), there is no real tax inefficiency to having the amount in excess of a specified target amount be returned to the grantor.

e. Use in Connection With Sale To IDGT.

Suppose a grantor would like to utilize another freezing technique, a sale to an intentionally defective grantor trust ("IDGT") but has no gift tax exemption remaining to make a seed gift to the IDGT. In this situation, the grantor can form a short-term GRAT that continues as a grantor trust following the expiration of the GRAT term. If all goes as planned, the grantor trust may have sufficient assets at the end of the GRAT term to support the sale transaction.

f. Avoid Funding on Multiple Dates.

The GRAT agreement must prohibit additional contributions to the trust. Because most GRATs are formed with a single asset, this is not usually a problem. In any event, the GRAT agreement should contain provisions to ensure an inadvertent transfer (or delay in funding) does not cause a problem. Practitioners may address this issue by either of the following: (1) including a provision in the GRAT that if additional property is contributed (or deemed contributed) to the GRAT that such property is required to be held in a separate trust under otherwise identical provisions, or (2)

providing that the GRAT shall remain revocable until the earliest date on which all assets intended to constitute the initial trust estate, as described in an attached schedule, have been transferred.

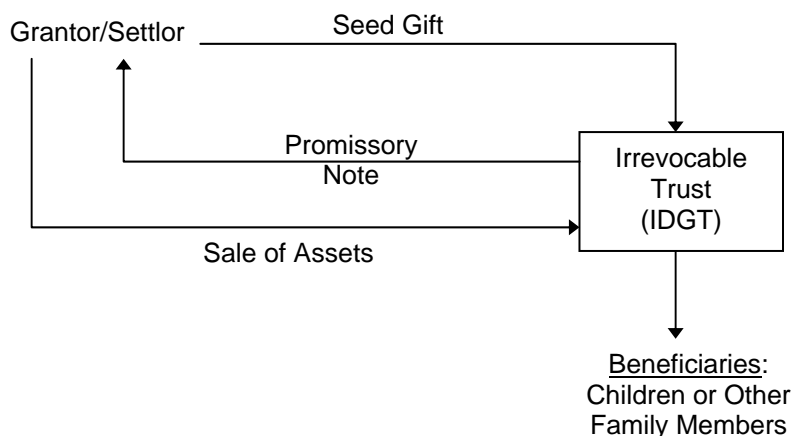
g. Use Percentage or Fraction as Payout.

An annuity may be expressed as a stated dollar amount or as a percentage or fraction of the initial fair market value of the assets. Practitioners should always express the annuity as a percentage or fraction of the initial fair market value. This is because a revaluation of the assets would only result in a larger annuity, rather than a larger taxable gift if the annuity was stated as a stated (specific) dollar amount.

h. Utilize the 105-Day Deferral Period.

The Regulations require that the annuity must be paid not less frequently than annually (or at least annually). Moreover, the Regulations provide a safe harbor and provide that any annuity paid within 105 days of the anniversary date will be treated as though it were timely made. Practitioners should always take advantage of this safe harbor to delay the required distributions from the GRAT for as long as possible. This will allow the GRAT, instead of the grantor, to earn income for an additionally 105 days on the annuity.

B. Sale To IDGT. Another popular estate planning freeze technique is a sale to an intentionally defective grantor trust (“IDGT”). A sale to an IDGT may be diagrammed as follows:



In simple terms, a defective grantor trust is an irrevocable trust arrangement intentionally designed to be disregarded for federal income tax purposes. In other words, a grantor trust is a trust under which the grantor is treated as the owner of the trust assets for income tax purposes. As such, transactions between the grantor and the trust have no federal income tax consequences during the lifetime of the grantor. At the same time, any

assets transferred to the trust during the lifetime of the grantor are considered to be completed transfers for federal estate and gift tax purposes. As such, the trust assets will not be included in the grantor's gross estate upon the grantor's death and are sheltered from claims of creditors.

The Internal Revenue Code provides several methods to create a defective grantor trust for income tax purposes. These rules are spelled out in detail under Sections 671 – 679 of the Code. A detailed discussion of these grantor trust rules are beyond the scope of this presentation. It will suffice to note that the most popular mechanism for creating a defective grantor trust is to give the grantor the power exercisable in his or her non-fiduciary capacity without the approval and consent of any trustee to reacquire the corpus of the trust by substituting other property of equivalent value.

There has been some concern in the estate planning area over the last few years that the substitution power could create a risk of estate inclusion. Earlier this year, however, the IRS issued Revenue Ruling 2008-22 indicating that the substitution power will not cause estate inclusion under Section 2036 or Section 2038 provided (i) the trustee has a fiduciary obligation to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact in equivalent value (generally state law provides for this), and (ii) further provided that substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

1. What Is The Defective Sale Transaction?

a. Initial Funding of the Trust.

Prior to any transaction between the grantor and the trust, it is important to initially provide the trust with economic viability. In other words, the trust should be sufficiently funded prior to any transaction. Under most circumstances, one or more seed gifts by the grantor to the trust will accomplish this purpose. While each transaction should be specifically evaluated, a good rule of thumb is to fund the trust with at least 10% of the amount of any proposed transaction. This initial seed gift will likely require the filing of a gift tax return and the allocation of GST exemption.

b. Sale of Assets to Trust.

The grantor and the trustee of the trust subsequently enter into an agreement whereby the trust agrees to purchase assets from the grantor.

(1) Purchase Price.

In order to avoid an unintentional gift by the grantor, the sale of the assets must be at fair market value.

[Planning Tip: In the case of an interest in a closely held business entity, an independent appraisal is strongly recommended.]

(2) Installment Sale.

The assets can be sold to the trust for an installment note, in whole or in part, for the fair market value of the assets. The note may be structured in a variety of ways. For example, it may provide for equal payments of interest and principal over the life of the loan. Alternatively, it may provide for annual interest only payments with a balloon principal payment at the end of the term. The note should provide the option of paying the principal in advance of the due date without penalty.

[Planning Tip: The note should be designed so that the trustee has a reasonable expectancy of paying off the note prior to the grantor's death.]

(3) Interest Rate.

In order to avoid the imposition of a gift, the note should provide for adequate interest payments at least equal to the applicable federal rate (AFR) under Section 1272. Because the goal of the transaction is to reduce the grantor's estate to the greatest extent possible, a lower rate is advantageous as it produces lower payments. The interest rate for a note term of not over three years should at least equal the short-term AFR. The interest rate for a note term of over three years but not over nine years should at least equal the mid-term AFR. The interest rate for a note term of over nine years should at least equal the long-term AFR.

[Planning Tip: The AFR rates are published by the Treasury well in advance of the first of each month. Prior to closing, practitioners should review published rates as it may be beneficial to close the transaction prior to rates going up. Alternatively, it may be beneficial to delay a closing to take advantage of a drop in the applicable AFR.]

(4) Necessity of an Economic Model.

It is essential to construct an economic model to assure that sufficient cash flow will be available to the trust to service the debt. Such cash flow may be available from interest and dividends earned and/or distributed by investment assets sold to the trust.

[Planning Tip: Without sound economic models, the trust may not have sufficient cash flow to meet its annual obligation. This could result, in the case of a transfer of a closely held business, in a return to the grantor of interests in the closely held entity. This would require an appraisal which can be expensive.]

(5) Adequate Security for Note.

The note should be secured by the assets sold utilizing a pledge agreement from the trust.

[Planning Tip: Depending on the circumstances, it may be appropriate to pledge the seed gift as security for the note as well.]

(6) Bona Fide Debt.

As stated above, the note may be constructed in a variety of ways. However, the transferred assets will be removed from the grantor's estate only if the note is in fact a bona fide debt. From a variety of previous holdings, courts have applied the following factors in determining the adequacy of indebtedness:

- (a) Evidence of a promissory note or other indebtedness;
- (b) Schedule for repayment;
- (c) Charged interest;
- (d) Collateral exists for indebtedness;
- (e) Repayments have been made; and
- (f) Borrower's financial solvency at time loan is made.

(7) Guaranty of Indebtedness.

The legitimacy of the transaction is significantly enhanced through the guaranty of the debt (or a portion thereof) by one or more beneficiaries of the trust.

[Planning Tip: Be selective about utilizing a guaranty. If the beneficiary does not have sufficient funds to support the guaranty, the use of the guaranty may actually do more harm than good.]

2. Advantages of Sale to IDGT.

a. Asset Freeze.

All subsequent appreciation in the assets sold to the trust are removed from the grantor/seller's estate.

b. Availability of Valuation Discounts.

The fair market value of certain assets, specifically interests in closely held businesses, sold to the trust may receive substantial valuation discounts based upon lack of marketability and lack of control. For example, an independent appraiser is likely to discount a limited partner interest in a family limited partnership sold by the grantor to the trust.

c. No Income Tax Consequences Resulting from Sale.

Because the trust is ignored, and its assets continue to be treated as assets of the grantor, for federal income tax purposes, there are no income tax consequences of the sale.

d. No Income Tax Consequences Resulting from Note Payment.

Once again, because the trust is not recognized for income tax purposes, the payment of interest to the grantor is not recognized as income (i.e., one cannot make taxable interest payments to oneself).

e. Payment of Trust Income Taxes by Grantor.

The grantor is taxed on any income generated by the assets of the Trust. While at first glance this appears to be a disadvantage of the transaction, in reality, this is the equivalent of a tax-free gift to the trust since no reimbursement from the trust is required. Simultaneously, these tax payments will further reduce the value of the grantor's taxable estate.

The grantor's payment of the federal income taxes on behalf of the trust does not give rise to a deemed additional gift to the trust. Additionally, if the tax liability becomes overly burdensome for the grantor, the trust may be drafted to provide a mechanism relieving the grantor of some or all of the tax liability generated by the Trust.

[Planning Tip: Always take extra precaution prior to terminating the grantor trust status of a trust. To the extent the note remains outstanding, the transaction would become taxable.]

f. Removal of Transferred Assets from the Grantor's Gross Estate.

The assets of the trust are not included in the grantor's taxable estate for federal estate and gift tax purposes. Of course, any remaining unpaid balance on the note will be includible in the grantor's estate.

g. Grantor's Indirect Retention of Control.

As stated above, the grantor must not possess any beneficial possession, enjoyment, or income in the trust assets for such assets to be excluded from the grantor's taxable estate. However, in some cases, the grantor may be able to retain an indirect form of "control".

Consider, for example, the sale of limited partner interests in a family limited partnership by the grantor to the trust. If the grantor retains the general partner interest in the partnership, the grantor continues to possess management control over the assets and activities of the partnership in his or her capacity as general partner and/or managing partner.

h. S Corporations.

The intentionally defective trust can qualify to own stock of an S corporation for so long as the grantor is alive with more flexibility than a QSST. However, extreme caution must be used to avoid unintentional inclusion of the stock in the grantor's taxable estate under Section 2036(b). A recapitalization of the corporation into voting and non-voting stock may be necessary.

3. Disadvantages Of Defective Sale.

a. Uncertain Income Tax Consequences Upon Grantor's Death.

In the event the grantor dies prior to the full satisfaction of the note obligation, gain may be recognized upon the grantor's death, but this issue is somewhat "unresolved." One common theory is that any payments received by the grantor's estate following the grantor's death should be characterized as income in respect of the decedent ("IRD"). As such, if the note is structured as a balloon note, the entire value of the note could be included as IRD.

Without a definite resolution of this issue, the Trust should make every attempt to pay the balance of the note prior to the grantor's death.

b. Adverse Income Tax Consequences Upon Termination of Grantor Trust Status.

In the event the Trust loses its grantor trust status during the grantor's lifetime and while the note is outstanding, the results could be undesirable. Such an event is characterized for income tax purposes as a disposition or transfer by the grantor, and significant gain recognition is likely to result. However, with careful planning, this situation can be avoided.

c. Depreciation in Asset Value.

The Trust bears the risk of a decline in the asset value of the Trust assets in a defective sale transaction. Regardless of the value of the Trust assets, the note obligation remains.

4. Comparison of Defective Sale to GRAT.

A Grantor Retained Annuity Trust ("GRAT") is a similar planning tool used to remove assets from a grantor's taxable estate without generating adverse income tax consequences. However, the use of the defective sale transaction has significant advantages over the GRAT.

a. Overview of GRATs.

A GRAT is an irrevocable trust which allows the grantor to gift a remainder interest in property to donees (usually children) and retain an annuity interest for life or for a term of years. At the end of the term, the remaining property will pass to the grantor's beneficiaries.

GRATs are statutorily recognized under Section 2702 of the Code. The Regulations under Section 2702 set out the specific requirements for GRATs which must be met for the value to be determined as described above.

b. Section 2702 Does Not Apply to Defective Sale.

The technical rules of Section 2702 do not apply to a sale to a defective trust.

c. Grantor Does Not Need to Survive Term.

Unlike a GRAT, the grantor does not need to survive the term of the promissory note to achieve the estate planning benefits of the defective sale transaction. Only the unpaid balance of the note should be includible in the grantor's taxable estate. With a GRAT, the grantor must generally outlive the trust term to remove the

transferred assets from the grantor's gross estate. [**Note:** Most GRATs are structured to have a very small initial gift, or in fact zero-out the initial gift. Accordingly, the value of the annuity payments equal the fair market value of the assets transferred. In these scenarios, even under the new proposed Regulations, in many cases, the partial inclusion analysis under Section 2036 will nevertheless result in full inclusion of the GRAT assets upon the death of a grantor.]

d. Lower Interest Rate.

As stated above, the promissory note should require interest payments at least equal to the AFR under §1272. Alternatively, the 7520 rate, used to value interests in a GRAT, is equal to 120 percent of the mid-term AFR rate. As such, the interest rate required for the promissory note is lower than the rate used to value the GRAT in the vast majority of circumstances.

e. Allocation of GST Exemption.

Unlike a GRAT, the grantor may allocate GST exemption to the seed gift, thereby making the entire trust free from the GST tax.

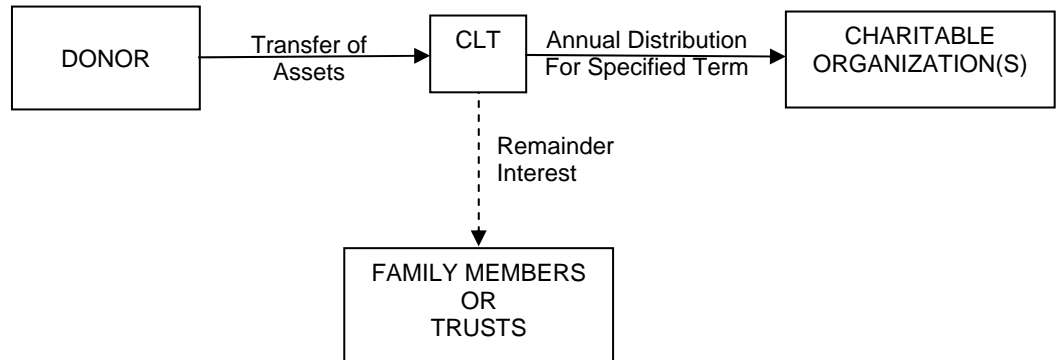
C. Charitable Lead Trusts. The charitable lead trust (or "CLT") is the opposite of a Charitable Remainder Trust (or "CRT"). In the CLT, property is transferred to an irrevocable trust which requires the payment of an annual annuity to one or more qualified charitable organizations, and the remainder interest is distributed to one or more private individuals or entities. In other words, the charitable interest precedes or leads the non-charitable remainder beneficiary. Unlike a CRT, a CLT is designed to make lifetime or testamentary transfers to the donor's children or grandchildren at the lowest gift or estate tax cost.

1. Requirements of CLTs.

The CLT may take the form of either a charitable lead annuity trust (or "CLAT") or a charitable lead unitrust (or "CLUT"). Treas. Reg. § 1-170A-6(c). The CLAT requires a guaranteed annuity equal to a sum certain payable not less than annually for a term or years or for the life or lives of an individual or individuals, each of whom must be living at the creation of the trust. In other words, the annual fixed annuity is either a specified dollar amount or more typically a percentage of the initial fair market value of the trust assets.

The CLUT is a trust which provides for a unitrust payment to a charitable beneficiary determined on an annual basis and is a fixed percentage of the fair market value of the assets determined on an annual basis. Note that if the CLT assets are appreciating in value, the CLAT would result in more assets passing to the remaindermen than would the CLUT.

A CLT has no minimum or maximum term or payout percentage.



EXAMPLE: Assume Donor transfers \$1,000,000 to a CLT and designates a charitable organization as a 5% annuity beneficiary for 10 years. At the current § 7520 Rate (2.4%), the value of the annuity is approximately \$440,000.

If established as a grantor trust, the Donor will report a taxable gift of \$560,000, the value of the remainder. Donor will also receive an immediate charitable income tax deduction equal to \$440,000. As a grantor trust, all items of income and expense will be reported on the Donor's individual income tax return; however, the Donor's will not receive an annual charitable deduction for the annuity amounts passing to the charities until the initial \$440,000 charitable deduction is recaptured.

If established as a non-grantor trust, the Donor's will report the same \$560,000 taxable gift as the grantor trust. There is no immediate charitable income tax deduction; however, the Trust will receive an unlimited charitable income tax deduction under § 642(c) for the annual payments to charity.

As a comparison, the same CLT established during December 2008 when the 7520 Rate was 3.4%, the taxable gift would have been \$582,000 and the charitable deduction would have been \$418,000.

2. Income Tax Rules for Non-Grantor Trust CLTs.

A CLT may be drafted as either a grantor trust or a non-grantor trust. A non-grantor trust CLT is taxed as a complex trust under Code Sections 661 and 662.

a. No Charitable Income Tax Deductions for Contribution to Non-Grantor CLT.

Unlike a CRT, which is a tax exempt entity, an immediate charitable tax deduction is not realized upon the contribution of assets to a non-grantor CLT. In contrast, an immediate charitable income tax deduction is available for contributions to a grantor trust CLT, as described further below in the outline.

b. Unlimited Charitable Income Tax Deductions to Trust.

As a Trust, amounts contributed to the charitable beneficiary in each year are fully deductible as a result of Code Section 642(c). Accordingly, a CLT will generate current income tax only if the amount required to be paid to the charitable organization in each year is less than the taxable income generated by the CLT in such year.

c. Unrelated Business Taxable Income.

To the extent the distribution to the charitable beneficiary is made from unrelated business taxable income ("UBTI"), the unlimited charitable income tax deduction is disallowed. However, the CLT may claim a charitable income tax deduction of such amounts, subject to the AGI limitations applicable to individuals.

3. Income Tax Rules for Grantor Trust CLTs.

If the CLT is designed as a grantor trust, the grantor remains taxable on the income earned by the Trust under Sections 671 et. seq.

a. Immediate Charitable Income Tax Deduction.

In a grantor CLT, the grantor receives an immediate charitable income tax deduction based on the value of the annuity interest reserved for the charity. As a result of this immediate income tax charitable deduction, the grantor receives no further charitable deductions for the annual annuity payments made to charity. In other words, the immediate income tax deduction is essentially

recaptured over the term of the CLT as the grantor is taxed on all of the income of the CLT. The Trust (and therefore the grantor) will, however, receive a charitable income tax deduction for distributions to charity in excess of the required annual annuity distributions to charity. Treas. Regs. Sections 1.170A-6(c) and 1.170A-6(d)(2). **[Note:** A grantor CLT may be a good idea when the grantor wants a large charitable deduction in a given year. For example, a year in which the grantor anticipates receiving an unusually large amount of income].

b. Change of Grantor Trust Status.

If the status of the Trust as a grantor trust changes as a result of the death or due to the relinquishment of certain powers by the grantor. Any portion of the initial charitable deduction in excess of prior income tax to the grantor is accelerated and taxed as ordinary income. I.R.C. Section 170(f)(2)(b).

4. Applicability of Private Foundation Excise Tax Rules.

As a general rule, all of the private foundation excise taxes imposed under Sections of 4941 through 4945 will apply to all CLTs. Additionally, the governing instrument of a CLT must contain specific prohibitions with respect to certain private foundation rules (Section 4947(a)(2) and Section 508(e)). An exception to the application of the excess business holdings and jeopardy investment restrictions applies if the present value of all charitable lead interests do not exceed 60% of the aggregate fair market value of the net assets contributed to the trust. This exception could allow the holding of closely held corporation stock.

5. Applicability of Deduction for Gift and Estate Tax Purposes.

Unless trust is drafted as a grantor trust, no charitable deduction is available for federal income tax purposes. However, a charitable deduction for gift and estate tax purposes is applicable. In other words, the gift of the remainder interest to the non-charitable beneficiary is reduced for federal gift and estate tax purposes by an amount equal to the present value of the interest passing to charity.

6. Generation Skipping Transfer Tax Issues.

As the CLT plan is in essence a deferred gift to the remainder beneficiaries, special attention must be paid to ultimate distributions and the generation skipping transfer tax (“GSTT”). The ability to allocate GST exemption to a CLT depends upon whether the CLT is a CLAT or a CLUT.

For a CLAT plan, one may not allocate generation skipping transfer tax exemption until the termination of the CLAT. Section 2642(e). Accordingly, if the remainder assets of an CLAT are to be distributed to “skip persons” then an additional generation skipping transfer tax may be assessed at the time of termination to the extent that the assets of the CRT distributed to such ‘skip persons’ exceed the then available GST exemption of the grantor.

In an CLUT plan on the other hand, one may exempt assets contributed to the Trust by allocating the grantor’s available GST exemption to the remainder interest calculated at the inception of the CLUT plan. Thus, the CLUT is preferable when the remainder interest will pass to grandchildren or other skip persons and where the trust assets are likely to appreciate substantially in value.

VI. RECENT FLP CASES.

A. *Astleford v. Commissioner, T.C. Memo 2008-128.*

1. Facts.

Mrs. Astelford (“Taxpayer”) and her husband established a general partnership consisting of a 3,000 acre tract of farm land in Minnesota. This general partnership was named Pinebend Development Company (“Pinebend”) in 1970. In 1995, Mr. Astelford passed away, and his 50% interest in Pinebend passed to a marital deduction trust for the benefit of Taxpayer. In 1996, Taxpayer created a Minnesota limited partnership (“AFLP”) and transferred her ownership interest in an elder-care assisted living facility with a stipulated value of \$870,904. Simultaneously on August 1, 1996, Taxpayer gave each of her three children a 30% limited partnership interest in AFLP, retaining for herself a 10% general partnership interest. On December 1, 1997, Taxpayer made an additional contribution to AFLP of her 50% Pinebend interest and her ownership interest in fourteen other real estate properties. Also on December 1, 1997, Taxpayer gave each of her three children additional limited partner interest in AFLP having the effect of reducing Taxpayer’s AFLP general partnership interest back down to approximately 10% and increasing Taxpayer’s children’s AFLP limited partner interest back up to approximately 30% each.

Taxpayer then filed 1996 and 1997 Federal Gift Tax Returns For both the 1996 and 1997 transfers of AFLP limited partner interest, the Taxpayer’s expert claimed a 40% combined lack of marketability and lack of control discount.

2. Tax Court Decision.

The Court determined that based on the facts, and an analysis of both Taxpayer's and the Service's experts, a 16.17% lack of control discount and a 21.23% lack of marketability discount (for a combined total discount of 33.96%) was applicable to the transferred limited partner interest.

The next issue regarding valuation discounts was the value of the 50% Pinebend general partner interest owned by the Taxpayer and transferred to AFLP prior to the gifts. The Taxpayer's expert indicated that a 40% combined discount was applicable, and the Court determined (again after analysis of Taxpayer's and Service's expert opinions) that a 30% combined discount was applicable to the general partnership interest.

3. Notes.

It is important to note that this case involved transfers of limited partner interest on the same date as the establishment of the partnership. It is unclear whether or not this issue was raised by the Service in the audit or in the Tax Court Petition, but it was not addressed by the Court.

It is also important to note that the Court allowed tiered discounts for the general partner interest transferred to the partnership. The Court noted that the 50% interest in Pinebend constituted less than 16% of the partnership's net asset value and was only one of fifteen real estate investments that were held by the partnership. Accordingly, it concluded that both lack of marketability and lack of control discounts were applicable at each entity level.

In valuing the general partner interest, however, the Court valued this interest as a general partnership interest rather than an assignee interest. The Court relied on a "substance over form" doctrine to value the interest as a general partner interest as opposed to an assignee interest.

B. Mirowski v. Commissioner, T.C. Memo 2008-74.

1. Facts.

Shortly before her death, Mrs. Mirowski established Mirowski Family Ventures, LLC. On September 1, 2001, Decedent transferred certain ICD patents to the LLC in return for 100% of the membership interest. Again on September 5, Decedent transferred approximately \$60,000,000 of marketable securities to the Family LLC and again on September 6th and 7th another approximate \$1,500,000 of marketable securities to the LLC. Following these transfers, Decedent retained 100% ownership of the LLC.

Then, on September 7th, Decedent gifted a 16% membership interest to separate irrevocable trusts established for her three daughters. The Decedent thereafter died on September 11, 2001. The Tax Court made the following findings of fact:

- a.** The family we had a long history of meeting to discuss financial affairs and view revenue produced by the ICD patents. These patents were a result of the Decedent's husband's lifetime effort to invent and market these medical devices over a substantial period of time. The revenue from these devices had increased significantly in the years prior to the Decedent's death.
- b.** The Court found that the Decedent retained outside of the LLC approximately \$3,000,000 in cash and cash equivalents, approximately \$7,500,000 of personal assets, a home worth approximately \$800,000, and art worth approximately \$1,800,000. The Court found that these assets retained outside of the LLC were sufficient to maintain the Decedent's lifestyle, but not enough to pay the gift tax associated with the gifted interests of the LLC to the daughters' trusts. The Court also found that the Decedent's death on September 11, 2001, following the gifts made on September 7, 2001, was essentially unanticipated, and that her death was not imminent. The Court also found that at no time did Decedent contemplate creating and funding the LLC without making the gifts to the daughters' trusts. Finally, the Court found that at no time was there an express or unwritten agreement or understanding among the members of the LLC that the Decedent, at her own discretion, could have access to any of the assets that she transferred to the LLC for her own possession or enjoyment, the right to income from those assets, or the right to determine who could possess or enjoy those assets.

Following Ms. Mirowski's death, the Decedent's Estate received a distribution of approximately \$36,000,000 which was used to pay the respective gift tax liability and federal estate taxes associated with the Decedent's gifts and Estate, respectively.

4. Tax Court Decision.

The Service contended that 100% of the value of the transferred assets to the LLC was includable in the Decedent's Estate under Sections 2036, 2038, or 2035.

With respect to the 2036 issue, the Court determined that the exception for transfers for a bona fide sale for adequate and full consideration in money or money's worth was applicable to the Decedent's transfer of her assets

to the LLC and therefore held that 2036 was not applicable to the gifts made to the daughters' trusts. In this regard, the Court noted that upon transfer of assets to the LLC, the Decedent retained a 100% ownership in the LLC. Further, the Decedent had a legitimate and significant non-tax reason for forming and transferring assets to the LLC. These reasons included (1) joint management of the family assets by her daughters and eventually grandchildren, (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if the Decedent were to make separate gifts of a portion of her assets to each of her daughters or their respective trusts, and (3) providing for each of her daughters and eventually each of her grandchildren on an equal basis.

The Court then addressed the Section 2038 and 2035 contentions by the Service and, for essentially the same reasons that the Court found that Section 2036 does not apply, the Court also found that neither Section 2038 nor 2035 applied.

5. Notes.

It is important to note that the creation of the LLC was not subject to Section 2036. It is also relevant that legitimate non-tax reasons for the establishment of the LLC allowed a bona fide sales exception to Section 2036. The Court essentially recognized basic estate planning as a bona fide non-tax reason for the establishment of the LLC, and the Court expressly noted that the Decedent could look to distributions from the LLC to pay Estate tax or could borrow against the LLC interest in order to raise funds to pay Estate tax.

E. ***Bianca Gross v. Commissioner, T.C. Memo 2008-221.***

1. Facts.

This gift tax case involved the establishment of a family limited partnership and addressed the issue of whether gifts of limited partner interest shortly after establishment would be deemed to be transfers of underlying partnership assets. In July of 1998, Bianca Gross ("Taxpayer"), a widow, and her two adult children agreed to establish a family limited partnership which she believed would encourage her daughters to work together and learn from her experience while preserving (as sole general partner) her control over the partnership's assets. She had several discussions with her daughters about the arrangement which culminated in an agreement between the Taxpayer and her daughters by July 15, 1998 to form a limited partnership. On July 15, 1998, Taxpayer caused a Certificate of Limited Partnership for "Dimar Holdings L.P." to be filed with the New York Department of State. She also caused the

Notice of formation of the partnership to appear in the New York papers, and on October 14, 1998, caused an Affidavit of Publication to be filed with the New York Department of State. On July 31, 1998, Taxpayer's daughters each drew checks for \$10 to the order of Dimar, and on November 16, 1998, Taxpayer drew a check for \$100 to the order of Dimar.

From the beginning of October 1998 through December 4, 1998, Taxpayer transferred ownership of shares of stock which were mostly, if not all, common shares of well-known publicly-traded companies. The fair market value of the portfolio on December 15, 1998 was \$2,158,646. On December 15, 1998, the Taxpayer executed a document styled "Deed of Gift" that indicated she was transferring to each named daughter a 22.25% interest as a limited partner in Dimar. At the December 15th meeting, the Taxpayer and the daughters also for the first time executed an agreement entitled "Partnership Agreement for Dimar Holdings LP" which provided for the same terms and agreements that the parties had agreed upon in July of 1998: (1) that the Taxpayer was the sole general partner, (2) that the limited partners had no right of withdrawal, nor could they transfer their interest without the consent of the Taxpayer, and (3) that no limited partner had the right to liquidate the partnership.

The Taxpayer then filed a Gift Tax Return for 1998 in which she reported the gifts valued at \$312,500 attributing a 35% combined lack of minority interest discount, lack of control discount, and lack of marketability discount.

Upon audit, the IRS claimed that each indirect gift was worth \$480,000 versus the \$312,500 as reported.

2. Tax Court Decision.

The Service's contention was that the partnership was not created until December 15, 1998 and that what was in effect transferred to the daughters were the underlying securities of the Taxpayer versus a partnership interest. They cited and relied on *Shepherd v. Commissioner*, 115 T.C. at 379. The Service contended that the transfer of the partnership interest was simply an indirect gift of the underlying securities which were contributed to the partnership on December 15th. The Court, however, noted that the partnership was established on July 15, 1998, and that transfers of the underlying securities to the partnership were completed on December 4, 1998. The Court, citing the *Holman* case, concluded that the Taxpayer bore a real economic risk of change in value of the partnership for the six days that separated their transfer of the shares to the partnership and the gift. They reached the same result here where 11 days had passed between Taxpayer's conclusion of her transfer of the securities to the partnership and her gifts of the interest in the partnership to her daughters,

and the Dimar securities were mostly, if not all, common shares of well-known companies. The Court noted that the step transaction doctrine does not cause us to change the actual order of transactions before us and concluded that the Taxpayer did not make indirect gifts of the Dimar securities to her daughters. They concluded that the form of the transactions here in question accords with their substance.

F. Holman v. Commissioner, 130 T.C. No. 12 (2008).

1. Facts.

Husband and wife (“Taxpayers”) established a family limited partnership on November 2, 1999. The initial partners of the partnership were the Taxpayers, an UTMA account established for a minor child, and an irrevocable trust established for their four minor children. Each of the partners contributed Dell stock to the partnership in return for a pro rata partnership interest. Thereafter, on November 8th, Taxpayers began gifting limited partner interests. They began transferring FLP interests to the grandmother as the UTMA custodian for their youngest daughter, and to the irrevocable trust. Later, they gifted FLP interests to other custodial accounts as well. The Trustee of the irrevocable trust, as well as the Taxpayers, made additional contributions of Dell stock to the FLP. As of 2/2/01, the irrevocable trust held a 44.29% limited partner interest, the Taxpayers each held a 5.04% limited partner interest and a 0.56% general partnership interest, and the custodial accounts held a combined 11.13% limited partnership interest. The Taxpayers filed gift tax returns for the gifted limited partnership interests applying a 49.25% discount. Upon audit, the Service substantially increased the gifts for 1999, 2000 and 2001. The Service’s position was stated as (1) the gifts, in substance, were indirect gifts of the stock as opposed to limited partner interests, (2) the Service argued that the Taxpayers’ interest in the FLP was more like interest held in a trust rather than interest in an operating business and should be valued accordingly, (3) the Service argued that the restriction on transferring or liquidating partnership interests found in the partnership agreement should be ignored for valuation purposes pursuant to 2703 and 2704, respectively, and (4) the Service stated that the lack of marketability or minority interest discount should only be 28%.

2. Tax Court Decision.

The Court first addressed the issue of the indirect gift. The Tax Court distinguished the *Shepherd* case and the *Senda* case. They indicated that the subsequent gifts of FLP interest to the Trustee and custodian did not occur until several days after the partnership interests had been transferred to the donees. The Court indicated that although the Taxpayers in the

present case had always planned to gift their FLP interest to their children, they did not make the gifts immediately. They waited five days.

However, with respect to the Section 2704 argument, the Court found no business purpose for the transactions. The FLP held Dell stock and did nothing else. The restrictions imposed on the transfer of stock are primarily for the purpose of preventing Taxpayers' children from wasting the assets or having them misappropriated. There is no business to protect. The Court determined that, under 2703, it would disregard the restrictions because it failed to constitute a bona fide business arrangement.

Lastly, the Court settled on discounts ranging from 14.34% to 4.63% for lack of control for the three years of gifts and a 12.5% discount for lack of marketability.

VII. CHECKLIST.

A. Current IRS Audit Practices Will Focus On the Role of Professionals in the Formation of FLPs.

1. Number and date of pre-formation meetings with older generation.
2. Agenda for each meeting.
3. Who attended each meeting.
4. Degree of understanding/participation by older generation partners.
5. If it is a "pre-packaged" FLP then details of promotional meeting(s), materials and costs.

B. Privileges.

1. A variety of evidentiary privileges may exist in the context of the formation process:
 - a. attorney-client;
 - b. work product; and
 - c. preparer privilege.
2. Waiver.

All privileges are waivable, and may be inadvertently lost in the formation process in a variety of ways, e.g., disclosure of otherwise privileged

information in the presence of an unprotected third party. Avoiding waiver requires care and planning.

3. Why do you care about evidentiary privileges?

a. You may not.

(1) It may simply be impractical to maintain privileges;

(2) You may have to waive anyway to show business purpose.

b. On the other hand, protection of formation activities may be significant in other contexts, e.g., if FLP is attacked by third-party creditor of partner.

C. **“Cleansing files,” do not do it.**

VIII. ASSET SELECTION FOR CONTRIBUTION TO AN FLP.

Case law demonstrates that the type of assets contributed to an FLP plays a role in the adjudication process – typically, bearing on the business purpose, but also providing a factual framework for a Section 2036 argument.

A. **Assets to avoid.** Personal assets of any partner, like personal residence, vehicles, home furnishings, recreational assets or property.

1. It is obviously difficult to show a business purpose for contributions in this category.

2. Continued use, without compensation, of contributed assets.

a. creates the appearance of a Section 2036/implied agreement argument;

b. creates a factual quagmire where partnership funds are used to maintain what amounts to a personal use asset;

c. do not rely on accounting entries to accrue rents, *see* Strangi;

d. while this typically involves older generation partners, it is not limited to them.

B. **Avoid contributions that undercut the pooling of assets concept that underlies the FLP, *see* Thompson.**

C. **Active business vs. passive investments.**

1. Repeated legislative attempts to create this distribution have been rejected – but courts continue to circle the issue under the guise of business purpose.
2. Clearly the contribution of an active business is a substantial advantage in defending the FLP.
3. However, purely passive investment portfolios have been acceptable where the FLP complied with state law requirements, *see Knight*.

D. Do you contribute assets that you anticipate will be needed to pay transfer taxes?

1. Safest answer is no. If the older generation retains sufficient assets to pay anticipated transfer taxes, the issue is avoided, but discounting is reduced.
2. If they are contributed:
 - a. The argument that FLP involvement in transfer tax funding is irrelevant since it occurs post-death is not working, *see Strangi*.
 - b. The loan option.
 - (1) Here the FLP loans funds back to the estate:
 - (a) loan would need to resemble a real business transaction to avoid problems with intra-family loans as discussed in *Thompson*; and
 - (b) how does estate pay back loan?
 - (2) Under best of circumstances the government can still argue implied agreement since the need for the loan was foreseeable and the related party nature of the transaction.
 - c. The distribution option.
 - (1) Here the FLP makes distributions to the partners, including presumably the estate.
 - (2) Distributions would have to be pro rata, so if there are substantial partners (other than the estate) this may be costly.
 - (3) Adverse income tax issues.

(4) Still possible for government to argue implied agreement.

E. Focus on Older Generation Retaining Sufficient Assets Outside the FLP.

1. We now have substantial authority requiring an analysis of:
 - a. Older generation's life expectancy;
 - b. Anticipated annual living expenses;
 - c. Comparison of those expenses to retained assets and income stream, without consideration of possible distributions from the FLP.
2. If retained assets are and/or income is insufficient this is a strong indicator of implied agreement.
3. This is a particularly difficult area to defend.
 - a. These are precisely the kind of discussions that may be awkward to have in the formation process.
 - b. Analysis inevitably occurs in hindsight and incurred expenses appear foreseeable.
 - c. It is typically unreasonable since all partners anticipate FLP distributions and it is not uncommon for partnerships to consider needs of partners in setting distributions – but this income source is not considered.
 - d. Easy to trust younger generation's intent, *see Thompson*.

IX. FRACTIONAL INTEREST DISCOUNTS.

A. Fractional Discounts for Undivided Interests in Real Estate. Historically, the IRS has maintained that discounts for undivided interests be limited to the costs of partitioning the property among the owners. This concept has been discredited by an overwhelming number of cases indicating that such discounts are applicable under circumstances indicating that the undivided nature of the interest would in reality affect the value of the interest upon a sale. In a recent case the Tax Court concluded a 15% discount was appropriate based on common sense and precedent alone. In that case, the taxpayer's expert was less than convincing in substantiating a 25% to 35% discount, but the Service provided no evidence that no discount was applicable. *Amile v. Commissioner*, T.C. Memo 2006-76.

1. Factors Supporting a Fractional Interest Discount.

a. Access and Use.

Co-tenants generally do not enjoy exclusive use or access to a portion of the property; rather, each co-tenant has equal access to and use of all of the property.

b. Lack of Control.

Co-tenants must approve all actions for the property.

c. Consent to Sale.

A sale of the entire property requires participation and consent of each co-tenant.

d. Costs of Partition.

A partition of the property requires costs, time and voluntary or involuntary participation of each co-tenant.

e. Limited Buyers.

There is generally a lack of mortgage financing available for the sale of an undivided interest, thereby limiting the potential buyers to those willing and able to pay cash.

f. Mortgage.

A single co-tenant generally cannot mortgage his interest to traditional third-party lenders as other co-tenants are generally adverse to encumbering their own interests.

g. Lack of Marketability.

There is limited or in some instances a non-existent market for the sale of an undivided interest in real property.

2. Cases Involving Fractional Interest Discounts.

a. *Amile v. Commissioner* (2006).

The Tax Court concluded that the decedent's 42% undivided interest in farmland was entitled to a 15% fractional interest discount based on common sense and precedent. The Estate

representatives provided expert testimony to the effect that a discount of between 25% and 35% was applicable to compensate a potential buyer for the lack of control, limited marketability, and low financing potential characteristics. The expert offered comparables that were remote both in time and location. As a result, the Court accorded no weight to his analysis. The Service, however, offered no evidence to rebut the Estate's evidence that some discount was appropriate. *Amile v. Commissioner*, T.C. Memo 2006-76.

b. *Baird v. Commissioner* (2001).

The Tax Court concluded that a 60% fractional interest discount was applicable to the ownership of timberland owned by a Louisiana Trust. The property consisted of 2,957 acres of noncontiguous acres of timberland in Sabine Parish, Louisiana. The case actually resolves the issues of both a husband's 14/65 undivided interest in the trust and a wife's 17/65 undivided interest in the same trust. Both died within a year of each other. Husband died first, and husband's Estate Tax Return was filed claiming a 25% discount. Wife's Estate Tax Return was later filed using a 50% discount, and at the same time husband's Return was amended to reflect a 50% discount.

The Service took the position in the Notice of Deficiency that the Estate was entitled to a fractional discount equal only to the cost of partition. In this case the Service's expert concluded that a revised timber inventory would cost approximately \$8,000, that a survey dividing the property in "lots" would cost about \$50,000, and that a partition suit would cost \$100,000. Under Louisiana law the cost of partitioning property is pro-rated to the owners, so the applicable discount was the total cost of partition (i.e., \$158,000) divided by the undivided interest. This resulted in a fractional discount of 3.37% for husband's Estate and 3.11% for wife's Estate. The Service essentially maintained this position through the trial. The Service's proffered expert at trial was deemed incompetent to testify.

The Estates produced three experts at trial. All three experts had discussions refuting the Service's position that a partition of the property could be accomplished at the said costs if at all. They then respectively determined that fractional interest discounts had a range of 7% to 82%, from 29% to 83%, and from 14 to 60%. The Court found the third expert especially compelling based on a study of comparable sales of fractional interests in the same market and extensive experience in dealing with such interests.

The Court first addressed the issue of partition and found that implicit in the partition analysis of the Service was that the tracts could be easily partitioned into equally valued lots and assumes that co-owners will cooperate and the partition would be voluntary or uncontested. Based on the facts that was unlikely. Accordingly, the Court found that a 60% fractional discount was applicable based on (1) the restrictions on sale or transfer of the property, (2) potential costs and fees associated with a partition or other controversy, (3) limited market for fractional interests, and (4) lack of control. *Estate of Baird v. Commissioner*, T.C. Memo 2001-258.

In an interesting development, the Estates appealed the Tax Court's denial of an award of administrative and litigation costs based on a finding that the Service's position was "substantially justified". The Fifth Circuit reversed and remanded finding that the Service's position that a fractional interest discount was limited to the cost of partition was not substantially justified. *Estate of Baird v. Commissioner*, 416 F.3d 442 (5th Cir. 2005).

c. *Estate of Forbes* (2001).

The Tax Court concluded that a 30% fractional interest discount was applicable to the ownership of Georgia timberland. This case involved the determination of the fair market value of two parcels of real estate held in a QTIP Trust included in the Estate of the surviving spouse. The Trust owned a 42 % fractional interest in one tract and a 42.9% undivided fractional interest in another tract. The two tracts combined approximated 5,354 acres. Much of the case involved the determination of the fair market value of the tracts as a whole. The Tax Court agreed with the Estate the value of the tracts as a whole was \$1,746,795. It then turned to the applicable fractional discount.

The Service's expert was unable to find any minority interest sales in the market area so instead used (1) a 1989 sale of an office building in Alabama, (2) a 1961 sale of a vacant lot in Alabama, and (3) a 1981 sale of a 1,600 acre tract in Georgia. According to the Service's expert, these resulted in a fractional interest discount of 25% to 64%. He then concluded that an 18% discount was appropriate for the estate's property. The Court disregarded this testimony.

The Estate offered two experts, one of which the court found persuasive. That expert determined that a 30% discount was applicable based on (1) minority interest, (2) market restrictions,

(3) difficulty in securing financing, and (4) costs of partition. This expert could also locate no comparables, but noted that local real estate brokers commonly used a 10% to 30% discount when liquidating partnerships. He also noted the specific characteristics of the property and possible family conflicts. *Estate of Forbes v. Commissioner*, T.C. Memo 2001-72.

d. *Stevens v. Commissioner* (2000).

Decedent died in 1993 owning a 50% undivided interest in three properties. The other 50% undivided interest was owned by a trust established by the Decedent's late husband and held in a testamentary trust. All three properties were commercial properties subject to long-term leases. The first property was a 1.2 million square foot site with a commercial building subject to a long-term lease to K-Mart. The Court determined that the value of this property was \$5.3 million. The second property was a 57,000 square foot site with a commercial building subject to a long-term lease to Walgreens. The value of the entire property was set at \$2,670,000. The final property was a 14,000 square foot site with a commercial building subject to a long-term lease to Wells Fargo. The fair market value of the entire interest was \$987,950.

The Estate had three witnesses and maintained that the applicable fractional discount was 35% on the K-Mart property, 30% on the Walgreens property, and 35% on the Wells Fargo property. The taxpayer's experts emphasized the fact that neither owner of the property had control, and that any potential buyer would consider the risk in terms of cost to partition, lack of liquidity of the real property, lack of marketability for resale, and the inability to finance without consent of the other owner. The Service's position was that a 10% fractional discount was applicable to the K-Mart and Walgreens property, and a 20% discount was applicable to the Wells Fargo property.

The Court finally concluded that a 25% discount is appropriate for all three properties. The Court rationalized adjusting taxpayer's discounts to 25% due to the fact that the properties were in average to very good condition, had remaining economic lives, all had good rental histories and credit-worthy tenants, and were well located.

In this regard, the Court's analysis can be criticized in the sense that the Court essentially left the taxpayer's experts' conclusions unassailed and, without explanation, substituted their own judgment to arrive at a 25% discount. Additionally, the factors

they cite (i.e., the quality of the properties and tenants) do nothing to speak to the lack of control or marketability.

Reducing the taxpayer's experts' discounts is almost in direct conflict with the Court's earlier statement that the costs of partition become less relevant when there are income-producing improvements.

The Court noted that the Service's expert looked only at the cost to partition the properties, and then increased the amount of the discounts for unspecified costs. The expert concluded that the need to discount for control or marketability was minimized because partitioning would cure any control problem. In this regard, the Court noted that the importance of partitioning costs is dependent on the circumstances of each case. Partition is a more viable approach where real property is unimproved. Where significant income-producing improvements are involved, partition is a less plausible approach.

e. Other Cases.

There are many other cases recognizing a fractional interest for undivided interests. The following cases indicate the type of property and the applicable discount:

- (1) *Wineman v. Commissioner*, T.C. Memo 2000-193 -- Type of property: Cattle ranch property; applicable discount: 15%.
- (2) *Busch v. Commissioner*, T.C. Memo 2000-3 -- Type of property: Agricultural realty; fractional interest discount: 10%.
- (3) *Brocato v. Commissioner*, T.C. Memo 1999-424 -- Type of property: Eight apartment buildings and one duplex; amount of discount: 20%.
- (4) *Williams v. Commissioner*, T.C. Memo 1998-59 -- Type of property: 50% undivided interest in timber and wetlands; amount of discount: 44%.

3. Range of Discounts.

Fractional-interest discounts have ranged from 15% to 60%. However, oftentimes courts will classify such discounts as minority interest discounts.

a. Illustrative Cases.

<u>CASE NAME</u>	<u>% FRACTIONAL INTEREST DISCOUNT ALLOWED</u>	<u>PROPERTY VALUED</u>
1. Estate of Sels v. Comm'r T.C.Memo 1986-501	60%	Timberland
2. Estate of Youle v. Comm'r T.C.Memo 1989-138	12.5% (which is all the taxpayer sought)	Real property
3. Estate of Wildman v. Comm'r T.C.Memo 1989-667	40%	Real property
4. Mooneyham v. Comm'r T.C.Memo 1991-178	15%	Real property
5. Estate of Feuchter v. Comm'r T.C.Memo 1992-97	15%	Real property
6. Estate of Pillsbury v. Comm'r T.C.Memo 1992-425	15% (taxpayer limited to discount claimed on return)	Real property
7. LeFrak v. Comm'r T.C.Memo 1993-526	30%	Real property
8. Estate of Cervin v. Comm'r T.C.Memo 1994-550	20%	Texas community real property
9. Williams v. Comm'r T.C. Memo 1998-59	44%	Timber and wetlands
10. Brocato v. Comm'r T.C. Memo 1999-424	20%	8 apt. buildings/1 duplex
11. Busch v. Comm'r T.C. Memo 2000-3	38%	Agricultural realty
12. Wineman v. Comm'r T.C. Memo 2000-193	15%	Cattle ranch property
13. Stevens v. Comm'r T.C. Memo 2000-53	25%	Commercial properties
14. Forbes v. Comm'r T.C. Memo 2001-72	30%	Timberland
15. Baird v. Comm'r 416 F.3 rd 442 (5 th Cir. 2005)	60%	Timberland
16. Amile v. Comm'r T.C. Memo 2006-76	15%	Farmland

B. Non-Real Estate Assets. A fractional discount is easy to conceptualize when considering real property. The concept becomes less clear when dealing with non-real estate assets. Nevertheless, an undivided interest in personal property should be entitled to the same considerations of lack of marketability and lack of control as real property interests. The following cases illustrate, while not as great, fractional discounts are still applicable to personal property.

Undivided Interest in Art Work.

In *Stone v. U.S.*, 100 AFTR 2nd 2007-5512, the District Court considered the value for estate tax purposes of the 50% undivided interest in 19 paintings held by the Estate of Lois M. Stone. The Court first determined that the total fair market value of the 19 paintings at issue was \$5,532,500, and that the starting point for determining the Estate's 50% undivided interest in the paintings was 50% of such number or \$2,766,250. At trial, the Court found that the 44% discount claimed by taxpayer's expert testimony was unpersuasive and further determined that the Estate was not entitled to a discount for appraisal fees. It then held that the Estate was entitled to a discount of 2% to account for the actual cost of selling the art by an auction house, as well as a discount of \$50,000 to account for legal fees required to enforce the hypothetical seller's right to partition. It also concluded that "some discount is appropriate to allow for uncertainties involved in waiting to sell the collection until after the hypothetical partition action is resolved." The Court then ordered the parties to meet and confer in an attempt to settle on an appropriate amount of such additional discount.

The parties, unable to reach an agreement, informed the Court of their inability to reach a compromise, at which time additional briefs were filed. This time, the Plaintiffs asked for a discount of 35%, and the Service argued that no discount was appropriate, but agreed to a 5% discount "in the spirit of compromise."

The Court, without the benefit of oral argument, disagreed with the taxpayer's position that although the finding of its expert was discredited, the methodology employed was accurate. In this regard, the taxpayer's expert indicated that art generally appreciates at 3% a year, but applied an 18% expected rate of return to calculate the net present value, and then added a 10% illiquidity premium. In its supplemental brief, taxpayers argued that this methodology was correct, but that a more appropriate discount rate would be 20%. The Court did not find this argument persuasive, and indicated that even if the methodology was appropriate, the 20% rate of return was unreasonable.

The Court then addressed the Service's argument that a total 5% discount would be applicable. After giving affect to the prior 2% discount and

\$50,000 in legal fees to partition, this would leave only an approximate 1.2% discount for the uncertainties involved in waiting for the partition action to become resolved. The Court noted, “While this discount appears to be relatively low, [taxpayers] have provided no evidence from which this Court can reasonably base any larger discount.” Accordingly, the Court found that the taxpayer was entitled to claim a 5% undivided interest discount on the Estate’s 50% interest in the art collection.

This case illustrates the extremely important need to choose a qualified persuasive expert in valuation cases. It appears that with some competent and persuasive arguments, a much larger discount could have been acquired for the taxpayer.