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TRANSFER TAX AUDIT AND LITIGATION ISSUES

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I. OVERVIEW

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

II. BASIC VALUATION PRINCIPLES

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

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

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

Beginning in early 1997, the Internal Revenue Service, through the issuance of technical advice memoranda and private letter rulings, embarked on a frontal assault on the use of family limited partnerships and other closely held entities for estate planning purposes. In these pronouncements, the National Office of the Internal Revenue Service took the position that an entity be completely disregarded for estate and gift tax purposes under various theories, whether or not that entity was validly created and existing under state law. *See*, *e.g.*, PLR 9736004 (June 6, 1997); PLR 9735043 (June 3, 1997); PLR 9735003 (May 8, 1997); PLR 9730004 (April 3, 1997); PLR 9725018 (March 20, 1997); PLR 9725002 (March 3, 1997); and PLR 9723009 (February 24, 1997). Since those pronouncements were issued, a number of these arguments have been decided by the courts.

A. I.R.C. § 2703 Argument

Sec. 2703. Certain Rights and Restrictions Disregarded

> (a) GENERAL RULE--For purposes of this subtitle, the value of *any property* shall be determined without regard to--
>
> (1) any option, agreement, or other right to acquire or use *the property* at a price less than the fair market value of *the property* (without regard to such option, agreement, or right), or
>
> (2) any restriction on the right to sell or use *such property*.
>
> (b) EXCEPTIONS--Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:
>
> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.

I.R.C. § 2703 (emphasis added).

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

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

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

In *Estate of Blount v. Commissioner,* T.C. Memo. 2004-116 (May 12, 2004), the Tax Court addressed the question of whether the redemption price in a modified buy-sell agreement controlled the value of a decedent's closely-held stock for federal estate tax purposes. The decedent ("D") and his brother-in-law each owned 50% of the outstanding shares of stock in a construction company. In 1981, D, his brother-in-law, and the company entered into an agreement that restricted transfers of the company stock during both the shareholder's lifetimes and at death. The agreement required the company to buy a deceased stockholder's stock at an established price. Unless redetermined by the parties to the agreement, the purchase price would be equal to book value. In 1992, the company created an ESOP. The ESOP later became a third minority shareholder. After the redemption of the brother-in-law's shares following his death in January 1996, D's shares constituted a controlling 83.2% interest in the company.

In 1996 (without obtaining the ESOP's consent), D and the company modified the agreement, changing the price and terms under which the company would redeem D's shares at death, but leaving unchanged the provisions requiring the consent of other shareholders for lifetime transfers. The modified

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