INSIGHTS & STRATEGIES

FINANCIAL AND ESTATE PLANNING

DECEMBER 2008

GIFT PLANNING

Expert's Article: *Holman and Gross* Cases Clarify Application of Indirect Gift in Fact and Step Transaction to Gifts of FLP Interests

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Two 2008 U.S. Tax Court decisions have clarified and narrowed the risk that discounts will not be allowed for gifts of family limited partnership (FLP) interests when the Service asserts, under the indirect gift doctrine, that what was actually transferred to the donees were FLP assets, rather than FLP interests. *Holman v. C.I.R.,* 130 T.C. No. 12 (May 27, 2008) and *Gross v. C.I.R.,* T.C. Memo. 2008-221 (Sept. 29, 2008). In both cases, the assets transferred to the FLPs by parents were marketable securities.

Indirect Gifts in Fact

In *Holman,* a sizeable block of Dell shares was transferred to an FLP; in a second step, a trust for the benefit of daughters acquired a 0.14 percent interest in the FLP in exchange for 100 Dell shares. Subsequently, gifts of FLP units were made to a custodial account for the benefit of one daughter and the trust. The Service claimed that the transfer was an indirect of the underlying FLP assets.

Under Reg. Sec. 25.2511-1(h)(1), a transfer of property by a shareholder to a corporation, without consideration, is a gift to the other shareholders. Prior cases where the indirect gift doctrine has been recognized are *Shepherd v. C.I.R.*, 115 T.C. 376 (2000), affd. 283 F.3d 1258 (11th 2002), and *Senda v. C.I.R.*, T.C. Memo 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006). The *Holman* judge distinguished his facts from these cases because in *Shepherd* and *Senda* the FLP interests were transferred before or at the same time as the assets were transferred to the FLP. In *Holman,* the FLP gifts were made six days after the FLP was funded. Hence, the indirect gift theory did not apply.

In *Gross*, the Service made the same indirect gift argument, but was rebuffed for the same reasons and by the same judge. In *Gross*, the Service also argued that, even though the certificate of limited partnership was filed, the partnership was not valid as a limited partnership until after the transfers because the limited partnership agreement was not signed until that time. This argument did not hold because, under New York law, a general partner-ship is created when the certificate is filed; its later transformation into a limited partnership is not relevant. Further, it was clear that the last transfer was made 11 days prior to the signing of the limited partnership agreement.

Step Transaction-Substance Over Form

The Service also argued for the application of the step transaction doctrine to disallow the discounts in both *Holman* and *Gross.* The step transaction treats a series of separate transactions as a single transaction if the separate steps are interrelated or interdependent on each other to achieve an ultimate purpose. In that event, the separate steps are treated as one transaction for tax purposes.

In both cases, the court concluded that the step transaction did not apply because the transferors bore the risk of loss during the time period from the transfer of the securities to the FLP until the transfer of FLP limited partnership interests. In the case of *Holman*, this was a six-day period, while in *Gross* it was at an 11-day period. What the parents transferred were FLP interests. They did not make indirect gifts of FLP assets.

Valuation and Discount Issues

Certain Restrictions Disregarded–Code Sec. 2703: In *Holman,* the court viewed the reason for the FLP structure as essentially an anti-spendthrift arrangement, as well as a deterrent against the beneficiaries selling the Dell stock. Accordingly, the critical "bona fide business arrangement" required under Sec. 2703 was lacking and the FLP's restrictions could not be taken into account for valuation purposes. This had the effect of reducing the discounts in *Holman.*

In *Gross,* the Court did not have to address Sec. 2703 because the Service had stipulated to a combined discount of 35 percent *if* the indirect gift doctrine were not found applicable by the Court. It appears likely that the Service was confident that it would, hence the stipulation of a combined discount which appears high for an FLP which owns blue chip equity securities. The Service was proven wrong.

Methodology: The *Holman* case also legitimizes the use of closed-end investment fund discounts as the basis for the lack of control discount. Such investments, although they are marketable, trade at a discount to net asset value. The court determined that the discount is attributable to some extent to a lack of control by minority shareholders. The court settled on 11%, 14% and 4% as of the various gift dates, indicating a preference for medians of funds' discounts rather than narrowing the field to replicate the subject FLP, which would be admittedly impossible since it only invested in one security.

The *Holman* case also determined the appropriate lack of marketability discount (LOMD) based on the Service's expert, who testified that the restricted stock sale studies averages need to be segregated based on the exact provisions of Rule 144 then in effect governing sales of non-registered stock in public companies. Pre-1990, there was no market for restricted stock, and the discount average was 34%. The SEC thereafter allowed restricted stock to be sold among institutional investors with a 2-year hold; the discounts dropped to 22%. Finally, in 1997, the rule was changed to allow a one-year hold, reducing the average discount to 13%. Using the discount change between the first and second period – and not the second and third – one can show that lack-of-access to the market can be estimated at 12%, the closest measure of the LOMD for an entity not subject to SEC rules. The average restricted stock discounts did register a 12% drop after 1990 when a market for restricted stock was, in effect, made for the first time.

The expert for the Service also testified that a theoretical negotiation between a partner wishing to sell and the other partners could hinge upon the fact that a liquidation followed by a reconstitution by the remaining partners would be in the interest of all partners at a discount of approximately 12%. The length of mandatory holding, which is a factor in the discount for restricted stock, would thus not appear to be a factor since the FLP assets are readily marketable and there are no statutory restrictions.

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Financial and Estate Planning: INSIGHTS & STRATEGIES (ISSN 1065-6413) is published 12 times per year and is available to the public at an annual subscription price of $125.00 or at a single copy price of $15.00 per issue. Subscription and single copy orders should be addressed to Sarah Thompson, Customer Services, Insights & Strategies, Financial Ink Corporation, P.O. Box 64299, St. Paul, MN 55164-0299. Phone number 651-665-5998, ©2008 Financial Ink Corporation, Executive Editor: Myron Kove; Assistant Editor: James M. Kosakow, (all of the firm of Kove & Kosakow, LLC). 212-822-0646. Facsimile 212-822-0648. DOFU 11-2008 A04151-1108