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TAX COURT CASE UPDATE

Citation:

Thomas H. Holman, Jr. and Kim D.L. Holman v. Commissioner, 105 AFTR 2010-1802, April 7, 2010.

Facts:

Thomas H. Holman, Jr. and Kim D. L. Holman created a limited partnership funded it with the common stock of Dell, Inc., and gifted limited partnership shares to their children. In a gift tax return, the Donors deducted lack of marketability and control discounts to claim a value for the gifts substantially below the value of the underlying Dell stock. The claimed discounts were based in part on transfer restrictions contained in the partnership agreement. The Holmans asserted that the transfer restrictions would depress the value of the partnership shares relative to the value of the underlying assets.

The IRS challenged the return, characterizing the gifts as gifts of Dell stock rather than gifts of limited partnership shares. In addition, it applied §2703 and disregarded the partnership agreement's transfer restrictions for valuation purposes. The IRS agreed that lack of marketability and control discounts should apply, but in smaller amounts than those claimed by the Holmans.

The Tax Court held that the gifts were gifts of limited partnership shares. It also held that the IRS correctly applied §2703 and properly disregarded the partnership agreement's transfer restrictions.

In addition, the Tax Court applied smaller discounts than those claimed on the gift tax returns. In doing so, it adopted the lack of marketability discount determined by the IRS's expert based on historical studies of restricted stock sales. The Tax Court noted that the partnership held only highly liquid, easily valued assets and that the agreement contained a consensual dissolution provision and granted broad management discretion to the general partners. According to the Tax Court, because economically rational partners would take advantage of the dissolution provision to dissolve and reconstitute the partnership or otherwise buy out a departing partner, there was a natural cap on any lack of marketability discount.

On appeal to the Eighth Circuit, Mr. and Mrs. Holman challenged the Tax Court's application of §2703 and other valuation issues.

Background on Transfer Restrictions:

Restrictions on the sale or use of property generally tend to depress the value of the property. Oftentimes, they serve legitimate business purposes, impose actual and meaningful limitations on the use or transferability of property, and are accepted by parties dealing with one another in arm's-length transactions. When carefully crafted and applied in certain circumstances, however, they can minimize the tax consequences of gifts or transfers without imposing substantial additional limitations on the transferability or use of the property, especially in the context of family transfers. Because of this, Congress enacted §2703(a), which broadly prohibits consideration of restrictions for valuation purposes, for agreements created or substantially modified after Oct. 8, 1990. However, §2703(b) allows taxpayers to prove eligibility for an exception that permits valuation based on such restrictions. To be eligible for the exception and gain the benefit of having such restrictions considered for valuation purposes, the taxpayer must satisfy a three-part test:

- The restriction must be "a bona fide business arrangement."
- It must not be "a device to transfer such property to members of the decedent's family for less than full and adequate consideration."
- Its terms must be "comparable to similar arrangements entered into by persons in an arm's-length transaction."

Valuation Restrictions Disregarded:

The Tax Court concluded that §2703(a) applied because the bona fide business and device tests were not met. The Eighth Circuit agreed that the bona fide business test was not met and therefore, there was no need to determine whether the other tests were met.

Looking at the entirety of the surrounding transactions, including the contemporaneous execution of wills, Mr. Holman's understanding of the potential tax benefits of his actions, Mrs. Holman's educational goals, and the absence of any business activity, the Eighth Circuit found ample support for the Tax Court's determination. The Court observed that, when viewed in this context, there was little doubt that the restrictions included in the Holmans' limited partnership agreement were not a bona fide business arrangement. Rather, they were predominately for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and teaching the children how to manage wealth. As a result, they upheld the Tax Court's decision.

Dissent:

Judge Beam dissented for several reasons. First, he felt that The Court stopped its analysis after only considering §2703(b)(1) and ignoring the two other tests under §2703. He disagreed with The Court's conclusion that there was no bona fide business purpose. He stated,

> Thus, I would hold that the Holman partnership agreement restrictions are 'bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preventing the partners' fundamental right to choose who may become a partner.

The second issue of the dissent dealt with §2703(b)(2). This code section specifically relates to decedents and since the Holmans are still alive (this was a gift tax case), the Holmans argued

that they satisfied the device test specified in this section. Judge Beam agreed that since the Holmans are living persons, they are by definition, not decedents, and therefore, §2703(b)(2) is met.

The Judge then went on to the comparable terms test in §2703(b)(3). There did not appear to be any argument that the terms in the agreement were comparable. Therefore, it appeared that all three prongs of §2703(b) were met and Judge Beam would have reversed and remanded the Tax Court's decision to perform the valuation without disregarding the partnership restrictions.

Finally, Judge Bean disagreed with the Tax Court's acceptance of the IRS's valuation analyst's discount for lack of marketability. According to the Judge, the Tax Court did not properly apply the willing buyer/willing seller construct. Rather, the lower court assumed that the partners would agree to dissolve the partnership and re-form it in order to buy out a partner because of the liquidity of the Dell stock that the partnership owned. However, this analysis does not consider that dissolving and buying out a "wishing-to-assign" partner may be contrary to the partnership's stated goals – maintaining control of family assets, continuing ownership of family assets, and restricting the ability of unrelated parties to acquire interests in family assets. Under this scenario, the willing buyer might find that the probability of the remaining partners agreeing to a dissolution and buyout is quite low.

This was not considered by the Tax Court and again, provided another reason for Judge Beam to suggest reversing and remanding the Tax Court's decision. An interesting result of this case is that under Holman, the government can now apply §2703 to gift tax cases (at least in the Eighth Circuit).